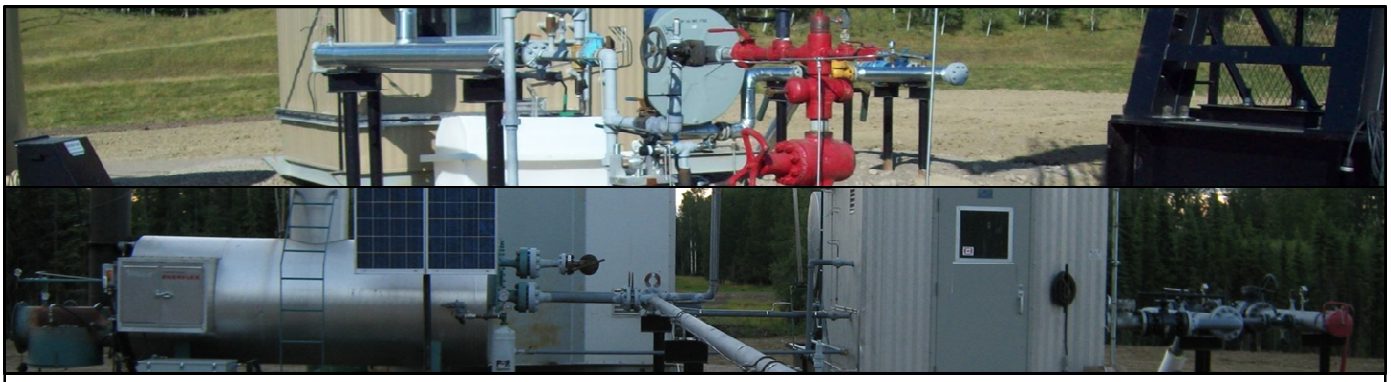

yangarra resources ltd.

Yangarra Resources Ltd.
2011 Annual Report

Yangarra Resources Ltd.
Management's discussion and analysis
December 31, 2011

Management's discussion and analysis ("MD&A") of the financial condition and the results of operations should be read in conjunction with the December 31, 2011 audited consolidated financial statements, together with the accompanying notes.

Additional information about Yangarra filed with Canadian securities commissions is available on-line at www.sedar.com.

The MD&A has been prepared using information that is current to April 4, 2012.

The financial information presented herein has been prepared on the basis of International Financial Reporting Standards ("IFRS"). Throughout this discussion, percentage changes are calculated using numbers rounded to the decimal to which they appear. All references to dollar amounts are in Canadian dollars.

***BOE Presentation** – Production information is commonly reported in units of barrel of oil equivalent ("boe"). For purposes of computing such units, natural gas is converted to equivalent barrels of oil using a conversion factor of six thousand cubic feet to one barrel of oil. This conversion ratio of 6:1 is based on an energy equivalent wellhead value for the individual products. Such disclosure of boe may be misleading, particularly if used in isolation. Readers should be aware that historical results are not necessarily indicative of future performance.*

***Special Note Regarding Non-IFRS Measures** – This MD&A includes references to financial measures commonly used in the oil and gas industry. The terms "net petroleum and natural gas revenue" (petroleum and natural gas sales less royalties, production expenses and transportation costs) and "funds flow from operations" (net loss for the period adjusted for non-cash items in the statement of operations before changes in non-cash working capital) are not IFRS measures and do not have standardized meanings prescribed by IFRS.*

***Forward-looking Statements** – Certain information regarding the Company set forth in this report, including management's assessment of the Company's future plans and operations, contain forward-looking statements that involve substantial known and unknown risks and uncertainties. These risks and uncertainties, many of which are beyond the Company's control, include the impact of general economic conditions and specific industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, the lack of available qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. The Company's actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements, and accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur, or if any of them do, what benefits the Company can derive from such events.*

Company Description and Outlook

Yangarra is a junior oil and gas company engaged in the exploration, development and production of natural gas and oil with operations in Western Canada, with a main focus on Central Alberta, where the Company has extensive infrastructure and land holdings.

Yangarra is dedicated to creating value for its shareholders through its commitment to a clear business strategy and performance objectives. The Company's strategy is to increase the value of its corporate assets through the drill bit and by assembling a large focused land base in Central Alberta that features high-quality, long-life light oil and liquids-rich gas reserves. The Company has assembled a significant future drilling inventory and will strive to grow this inventory through drilling, geology and strategic acquisitions.

During the year ended December 31, 2011 the Company completed the following significant milestones:

- Average daily production for 2011 was 1,205 boe/d a 137% increase from 2010. Fourth quarter 2011 production was 1,720 boe/d (49% oil and NGL's), which is a 37% increase from the third quarter 2011.
- Oil and gas sales during the year were $20.7 million a 217% increase from 2010 and cash flow from operations were $16.3 million ($0.15 per share - basic) a 452% increase from 2010. Fourth quarter 2011 oil and gas sales were $7.6 million with cash flow from operations of $5.7 million ($0.05 per share - basic) a 40% and 16% increase from the third quarter of 2011, respectively.
- Operating costs for 2011, including $0.79/boe of transportation costs, were $8.18/boe this represents a 27% decrease from 2010.
- Operating netback of $38.15 per boe, a 58% increase from the $24.12 per boe reported in 2010.
- Capital expenditures were $64 million for 2011 and $20 million in the fourth quarter of 2011.
- As at December 31, 2011, the Company had a working capital deficit of $34 million (excluding mark to market on commodity contracts and non-cash flow through share premium obligations) resulting in a debt to annualized trailing quarter cash flow ratio of 1.49 to 1. However due to a step change in the production levels in the month of December 2011, the annualized the December cash flow results in a debt to cash flow ratio of 0.97 to 1.

Operations Update:

- The Glauconite and Cardium plays are currently the primary focus of the development plan and combined with the Viking play represent over five years of currently identified drilling inventory.
- Production averaged 2,270 boe/d for the month of December. Two wells that were flowing at a combined rate of 600 boe/d net to Yangarra were shut-in by the operator for the months of December 2011 and January 2012 to allow for drilling on multi-well pads and for the installation of incremental compression.
- All dry gas production of approximately 1.2 mmcf/d (200 boe/d) was shut in early January 2012.
- The planned 2012 capital expenditures have been reduced from $50 million to $35 million. With the revised capital budget the Company will drill 16 gross (8.5 net) horizontal wells with an increased focus on wells with high oil and natural gas liquid ("NGL") volumes.

Summary Financial Information

	2011 Q4	2011 Q3	2010 Q4	Year ended 2011	Year ended 2010
Statement of Operations and Deficit					
Net income (loss) for the period (before tax)	$ (3,142,348)	$ 5,424,074	$ (1,037,921)	$ 4,872,697	$ (2,599,497)
Net income (loss) for the period	$ (2,155,583)	$ 4,106,091	$ (183,574)	$ 1,385,698	$ (1,745,150)
Net income (loss) per share - basic	$ (0.02)	$ 0.04	$ 0.00	$ 0.01	$ (0.03)
Net income (loss) per share - fully diluted	$ (0.02)	$ 0.03	$ 0.00	$ 0.01	$ (0.03)
Weighted average number of shares - basic	116,336,405	116,307,057	73,869,598	105,960,324	57,581,832
Weighted average number of shares - fully diluted	123,740,262	124,209,770	80,497,022	113,781,122	57,581,832
Statement of Cash Flows					
Funds flow from operations	$ 5,686,411	$ 4,967,853	$ 1,567,756	$ 16,341,180	$ 2,959,286
Funds flow from operations per share - basic	$ 0.05	$ 0.04	$ 0.02	$ 0.15	$ 0.05
Funds flow from operations per share - fully diluted	$ 0.05	$ 0.04	$ 0.02	$ 0.14	$ 0.05

	Year ended 2011	Year ended 2010
Balance Sheet		
Property and equipment	$ 119,374,220	$63,263,452
Total assets	$ 141,291,044	$68,373,813

Business Environment

	Year average 2011	Year average 2010
West Texas Intermediate ("WTI") (US$/bbl)	$ 95.05	$ 77.19
AECO gas (Cdn$/GJ)	$ 3.49	$ 4.08
Foreign Exchange (Cdn$/US$)	$ 1.01	$ 0.97

Crude oil prices strengthened during 2011, with the West Texas Intermediate (WTI) reference price averaging US$95.05 per barrel compared with US$77.19 per barrel in 2010. Demand for crude oil is generally tied to global economic growth, but is also influenced by factors such as political instability, market uncertainty, weather conditions and government regulations.

In 2011, the political instability in several Middle Eastern and North African countries contributed to the increase in crude oil prices. The uncertainty related to the debt crisis in the US and several European countries and the potential effect on global economic growth also contributed to the volatility in oil prices in 2011. The WTI forward strip price for 2012 is currently approximately US$109.

Oil prices in Canada are also affected by the Canada/U.S. dollar exchange rate since the WTI reference price of oil is in U.S. dollars. During 2011, the Canadian dollar strengthened slightly against the U.S. dollar, averaging US$1.01 to Cdn$1 compared with US$0.97 to Cdn$1 in 2010. The strengthening of the Canadian dollar partially offsets the increased WTI benchmark pricing experienced during 2011.

AECO natural gas prices for 2011 decreased to $3.49 per GJ from $4.08 per GJ in 2010. Demand from the price sensitive power and industrial sectors and warm weather patterns in the Northeast part of the United States temporarily offset the strong incremental production from shale gas plays. Strong US natural gas production is limiting the upside to natural gas price recovery.

Results of Operations

Net petroleum and natural gas production, pricing and revenue

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Daily production volumes					
Natural gas (mcf/d)	4,740	4,161	2,564	3,874	2,151
Oil (bbl/d)	536	384	260	361	116
NGL's (bbl/d)	258	132	54	145	28
Royalty income (boe/d)	136	44	19	53	6
Combined (boe/d 6:1)	1,720	1,253	761	1,205	509
Product pricing (includes royalty income)					
Oil ($/bbl)	$93.54	$89.25	$ 80.54	$ 92.79	$ 74.70
NGL ($/bbl)	$55.18	$54.00	$ 62.20	$ 58.60	$ 56.04
Gas ($/mcf)	$3.55	$3.93	$ 3.93	$ 3.92	$ 3.92
Combined ($/boe)	$49.88	$47.85	$ 40.94	$ 48.55	$ 35.55
Revenue					
Petroleum & natural gas sales - Gross	$ 7,555,427	$ 5,378,932	$ 2,864,802	$ 20,742,259	$ 6,534,377
Royalty income	$ 335,618	$ 137,243	$ 93,882	$ 613,139	$ 123,106
Royalty expense	$ (563,262)	$ (209,529)	$ (128,984)	$ (972,706)	$ (165,309)
Petroleum & natural gas sales - Net	$ 7,327,783	$ 5,306,646	$ 2,829,700	$ 20,382,692	$ 6,492,174

Petroleum and natural gas sales increased by 217% in 2011 to $20.7 million from $6.5 million in 2010, the increase is attributable to:

- a 37% increase in average product prices; and
- a 137 % increase in production (on a boe basis).

The increased production in 2011 can be attributed to additional wells that were brought on production during 2011. The Company drilled or participated in 29 gross (15.5 net) horizontal wells during 2011.

The overall average price earned by the Company was higher when compared to 2010 due to increased oil and natural gas liquids production (44% compared to 28% in 2010). The price of WTI increased by 23% and the price of natural gas deceased by 14% from 2010 and as a result the increased revenue from the oil and NGL production stream more than offset the decrease in the natural gas prices.

Fourth Quarter

Petroleum and natural gas sales increased by 40% in the fourth quarter of 2011 to $7.6 million from $5.4 million in the third quarter, the increase is attributable to:

- a 4% increase in average product prices; and
- a 37% increase in production (on a boe basis).

The Company continued to increase production and the overall average price earned by the Company was higher when compared to the third quarter due to increased oil and natural gas liquids production (49% compared to 42% in the third quarter).

Royalty Income

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Royalty Income	$ 335,618	$ 137,243	$ 93,882	$ 613,139	$ 123,106

Royalty income increased significantly in 2011 to $613,139. The majority of royalty income is a result of the 15% sliding scale royalty purchased in the Willesden Green area in March 2010. At the end of 2010 four wells had been drilled on the royalty lands and during 2011 an additional eight wells were added bringing to the total to 12 wells generating the 15% royalty income. Yangarra purchased the 15% overriding royalty from a 3rd party in 2010. As Yangarra owns a working interest in the royalty land a portion of the royalty is deemed inter-company and eliminated, however, if Yangarra had not purchased the royalty, total royalty paid to the 3rd party would have been approximately $1.5 million

Fourth Quarter

In the fourth quarter six wells were drilled on the royalty lands increasing the royalty income by $198,375 from the third quarter of 2011. In addition, as the majority of the new wells were not online at year-end royalty income is expected to increase further in the first quarter on 2012.

Royalty Expense

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Royalty Expense	$ 563,262	$ 209,529	$ 128,984	$ 972,706	$ 165,309
Per boe	$3.56	$1.82	$ 1.84	$ 2.21	$ 0.90
As a % of sales	7%	4%	5%	5%	3%

Royalties increased to $972,706 for the year ended 2011 or 5% as a percentage of sales. The increase results from higher production during 2011 and two wells transitioning from the 5% horizontal well royalty framework to a full royalty burden.

Generally, royalty rates in Western Canada are sensitive to prevailing commodity prices and individual well production rates. The crown royalty rate on the new horizontal wells in Central Alberta is 5% for the earlier of 2 years or 60,000 boe of production.

Fourth Quarter

Royalties increased from $209,529 in the third quarter 2011 to $563,262 for Q4 2011, the increase results from a full quarter with the two wells that transitioned from the 5% horizontal well royalty framework to a full royalty burden.

Production and Transportation Costs

	2011 Q4	2011 Q3	2010 Q4	Year ended 2011	Year ended 2010
Production costs	$ 1,231,655	$ 742,035	$ 738,831	$ 3,248,011	$ 1,820,683
Per boe	$ 7.78	$ 6.44	$ 10.56	$ 7.38	$ 9.91
Transportation costs	$ 71,273	$ 116,075	$ 72,990	$ 348,431	$ 237,893
Per boe	$ 0.45	$ 1.01	$ 1.04	$ 0.79	$ 1.29

Production and transportation costs increased in 2011 to $3,596,442 on a dollar basis and decreased by 27% on a per boe basis when compared to 2011. The decrease is due to additional production volumes that have allowed the Company to achieve more economies of scale. This is due to improvements in the Company's operating practices and due to increased production in areas with facilities in place and where the majority of the costs are fixed.

Fourth Quarter

When compared to the third quarter of 2011, production costs on a per boe basis have increased by 11% due to delays in production coming on-line from fourth quarter drilling. Additional costs were incurred in anticipation of the new production and once the new wells are brought on-stream the Company expects production costs per boe to fall back in line with the yearly average.

Operating Netback

	2011 Q4	2011 Q3	2010 Q4	Year ended 2011	Year ended 2010
Revenues	$ 46.09	$46.31	$ 40.94	$ 47.16	$ 35.55
Royalty income	3.79	1.55	1.34	1.39	0.67
Royalty expense	(3.56)	(1.82)	(1.84)	(2.21)	(0.90)
Production costs	(7.78)	(6.44)	(10.56)	(7.38)	(9.91)
Transportation costs	(0.45)	(1.01)	(1.04)	(0.79)	(1.29)
Netback per boe	$ 38.08	$ 38.58	$ 28.84	$ 38.15	$ 24.12

Netbacks increased by 57% when compared to the year ended 2010. Netbacks were stronger due to higher oil and liquid sales and, therefore, higher prices for natural gas. The higher oil and liquid sales were a result of the Company's focus on Glauconite and Cardium wells in Willesden Green/Ferrier versus the gas-weighted Medicine Hat and Jaslan areas. The Company has also lowered operating costs as economies of scale are being realized in Central Alberta due to increasing volumes.

Fourth Quarter

The fourth quarter 2011 netback of $37.34 per boe is a 3% decrease from the $38.58 per boe reported in the third quarter of 2011. The decrease in netbacks from the third quarter of 2011 is due to decreased commodity prices and increased operating costs in the fourth quarter.

Depletion, depreciation and accretion

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Depletion and depreciation	$ 3,279,485	$ 2,253,782	$ 1,562,204	$ 8,304,505	$ 3,811,668
Per boe	$ 20.73	$ 19.55	$ 22.31	$ 18.88	$ 20.52
Accretion	$ 23,416	$ 30,067	$ 33,583	$ 107,281	$ 126,628

Depletion and depreciation increased in 2011 compared to 2010 due to significant increases in capital expenditures and production in 2011. On a per boe basis, the reserve base increased from 2010, which has more than offset the increased production, resulting in a decreased DD&A rate per boe in 2011.

Fourth Quarter

The increase in DD&A on a boe basis from the third quarter of 2011 is due to the timing between the capital spent in the quarter and the production on-stream times.

General and Administrative expenses ("G&A")

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Gross G&A expenses	$ 819,829	$ 539,781	$ 542,819	$ 2,552,677	$ 1,470,821
G&A recoveries	$ (431,140)	$ (294,355)	$ (161,988)	$ (1,178,506)	$ (309,246)
Net G&A expenses	$ 388,689	$ 245,426	$ 380,831	$ 1,374,170	$ 1,161,575
Per boe	$ 2.46	$ 2.13	$ 5.44	$ 3.12	$ 6.25

General and administrative expenses increased by 18% in 2011 due to additional staffing and office requirements to manage the increased production levels. G&A recoveries also increased in 2011 as a result of additional partners on the Yangarra operated wells. On a per boe basis G&A decreased by 50% due to increased efficiencies in head office operations.

Fourth Quarter

G&A costs in the fourth quarter increased form the third quarter due to increased consulting costs required to manage the additional activity during the quarter, however, on a per boe basis G&A costs increased by 16% when compared to the third quarter.

Other expenses

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Interest and financing fees	$ (6,231)	$ 69,541	$ 94,780	$ 213,866	$ 265,251
Dividends on preferred shares	$ -	$ -	$ 12,603	$ 8,960	$ 50,000
Stock-based compensation	$ 258,300	$ 148,828	$ 961,984	$ 1,682,583	$ 1,746,939

Interest and financing fees for 2011 is for interest on the revolving operating demand loan for which the average amount drawn in 2011 was $15 million compared to $6 million in 2010.

The increase in stock-based compensation is a result of options granted to new employees.

Dividends on preferred shares are at a rate of 5% payable semi-annually in cash or common shares of the Company on $1,000,000 of preferred shares issued in December 2009 in conjunction with the settlement of the subordinated credit facility. The preferred shares were redeemed in March 2011 resulting in the reduced dividend paid for the first half of 2011.

Fourth Quarter

The average amount drawn on the revolving operating demand loan in the fourth quarter of 2011 was $17 million, however, the increased interest was offset by an adjustment by the bank for an over payment of interest in the second and third quarter.

Income Taxes

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Deferred Income Tax (recovery) expense	$ (986,765)	$ 1,317,983	$ (854,347)	$ 3,486,999	$ (854,347)

The Company's effective tax rate for 2011 was approximately 26.5%, however, Yangarra did not pay income taxes in 2011 and does not expect to pay income taxes in 2012 as is has sufficient tax pools to cover.

The Company has the following estimated tax pools as at December 31:

		Year ended	
	Rate %	2011	2010
Canadian exploration expenses	100	$ 7,995,628	$ 8,408,719
Canadian development expenses	30	54,255,805	20,573,717
Canadian oil and gas property expenses	10	10,282,395	7,642,652
Undepreciated capital costs	10-30	21,672,917	16,507,709
Non-capital losses (various expiry dates)	100	375,794	1,434,634
Share issuance costs	5 Years	2,686,066	1,547,617
		$ 97,268,605	$56,115,048

Commodity price risk contracts

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Commodity contract settlement	$ 161,775	$ 834,284	$ (32,766)	$ 1,269,687	$ 40,734
Change in fair value of commodity contracts	$ (5,385,319)	2,888,898	(6,270)	(1,491,875)	113,361
	$ (5,223,544)	$ 3,723,182	$ (39,036)	$ (222,188)	$ 154,095

As at December 31, 2011, the Company was committed to the following commodity price risk contracts for the sale of oil:

2012 Hedges:

- 100 barrels per day from January 1 to December 31, 2012 at a fixed price of $99.00 CAD per barrel;
- 200 barrels per day from January 1 to December 31, 2012 at a fixed price of $97.00 CAD per barrel;
- 200 barrels per day from January 1 to December 31, 2012 at a fixed price of $90.00 CAD per barrel;
- 100 barrels per day from January 1 to December 31, 2012 at a fixed price of $93.25 CAD per barrel; and
- 100 barrels per day from January 1 to December 31, 2012 at a fixed price of $100.00 CAD per barrel.

2013 Hedges:

- 200 barrels per day from January 1 to December 31, 2013 at a fixed price of $98.00 CAD per barrel; and
- 100 barrels per day from January 1 to December 31, 2013 at a fixed price of $97.50 CAD per barrel.

In addition, the Company entered into collars which provided a floor and a ceiling for the price it received for oil as follows:

- 100 barrels per day from January 1 to December 31, 2012 at a floor price of $95.00 CAD per barrel and a ceiling price of $110.00 CAD per barrel; and
- 100 barrels per day from January 1 to December 31, 2012 at a floor price of $95.00 CAD per barrel and a ceiling price of $109.15 CAD per barrel.

As at December 31, 2011, the Company was committed to the following commodity price risk contracts on the AECO basis:

- 2,000 mmbtu/day of AECO Basis for Nov11-Mar12 at a price ranging from -$0.38 to -$0.42 USD/mmbtu.

The mark-to market on the hedges was in a loss position of $1,491,875 as at December 31, 2011. During the year ended December, 2011 $1,269,687 (2010 – $40,734) worth of contracts were settled.

Liquidity and Capital Resources

During the year ended 2011, the Company generated $16,341,180 of funds flow from operations compared to $2,959,286 in the 2010 comparative period. Funds flow from operations was higher for the 2011 period due primarily to the increase in petroleum and natural gas revenue.

As at December 31, 2011, the $26,245,533 (2010 – $5,559,208) reported amount of bank debt was comprised of $24,450,000 (2010 – $4,600,000) drawn on the revolving operating demand loan and $1,795,533 (2010 – $959,208) of bank overdraft. The Company is subject to a financial covenant with respect to working capital, which the Company was in compliance with at December 31, 2011. The facility is secured by a fixed and floating charge on the assets of the Company and is secured by a general security agreement.

As at December 31, 2011, the maximum amount available under the revolving operating demand loan was $40,000,000 (December 31, 2010 – $12,000,000) at an interest rate of bank prime plus 1.0% per annum, payable monthly.

The Company is compliant with all debt covenants as at December 31, 2011.

As at December 31, 2011, the Company had a working capital deficit of $34 million (excluding mark to market on commodity contracts and non-cash flow through share premium obligations) compared to a deficit of $12 million at December 31, 2010.

Annualizing the three month cash flow ending December 31, 2011 and using the December 31, 2011 working capital amount (excluding commodity contract liability and the flow through liability) the Company has a debt to cash flow ratio of 1.49 to 1. However, due to a step change in the production levels in the month of December 2011, the annualized December cash flow results in a debt to cash flow ratio of 0.97 to 1.

Capital Spending

Capital spending is summarized as follows:

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Land and lease rentals	$ 740,630	$ 953,884	$ 3,827,343	$ 3,782,231	$ 5,449,298
Drilling and completion	15,727,731	14,892,270	10,593,594	49,808,464	16,777,716
Geological and geophysical	162,825	359,277	190,640	947,870	505,583
Equipment	3,104,371	2,799,884	2,148,426	9,487,625	4,272,875
	$ 19,735,557	$19,005,315	$16,760,003	$ 64,026,190	$27,005,472

The Company drilled or participated in 29 gross (15.5 net) horizontal wells during 2011 and purchased 92 sections of land. The drilling resulted in significant increases in production, proved the Rock Creek play and allowed the Company to drill industries first horizontal well in the Second White Specks reservoir.

The average drill and complete cost per well was $3.2 million mainly as a result of drilling deeper wells with more complicated fracture programs. As a result of reduced costs and improved drilling and fracturing efficiencies the Company is forecasting a per well drill and complete cost of $2.6 million in 2012.

The planned 2012 capital expenditures have been reduced from $50 million to $35 million. With the revised capital budget the Company will drill 16 gross (8.5 net) horizontal wells with an increased focus on wells with high oil and natural gas liquid ("NGL") volumes. The Company will operate the 2012 drilling program with one drilling rig instead of two drilling rigs as previously planned.

Decommissioning Liabilities

As at December 31, 2011, the undiscounted fair value of the decommissioning liability associated with the Company's existing properties was estimated to be $6,120,528 for which $4,898,222 has been recorded using a discount rate of 1.51% - 3.35%, an inflation rate of 2% and an estimated weighted average timing of cash flows of 8.7 years.

Off Balance Sheet Arrangements

There were no off balance sheet arrangements, other than the office commitments and truck lease commitments which are accounted for as an operating lease.

Related Party Transactions

During the year ended December 31, 2011 and 2010, the Company was charged or invoiced the following amounts by certain of its officers and directors and by companies controlled by certain of the Company's officers and directors:

	2011		2010	Year ended	
	Q4	Q3	Q4	2011	2010
Administration and consulting fees	$ 60,000	$ 51,284	$ 35,055	$ 237,694	$ 168,270
Production and capital expenditures	104,451	113,886	87,698	339,896	614,056
	$ 164,451	$ 165,170	$ 122,753	$ 577,590	$ 782,326

Included in accounts payable and accrued liabilities at December 31, 2011 is $117,020 (December 31, 2010 – $29,668) relating to the above transactions. These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

During the year ended December 31, 2011 the Company entered into a trust agreement with an officer of the Company for an asset in Central Alberta used a field office. The Company holds the asset in trust while the officer retains legal title.

Share Capital

Details of changes in the number of outstanding equity instruments are detailed in the following table:

	Common Shares	Preferred Shares	Warrants	Stock Options
Balance - December 31, 2010	**79,718,127**	**1,000,000**	**9,452,000**	**7,808,800**
Transfer agent correction	(70)	-	-	-
Financing March 2011	23,632,500	-	-	-
Financing June 2011	12,500,000	-	-	-
Grant of options	-	-	-	4,175,000
Exercise of options	260,000	-	-	(260,000)
Expiry of options	-	-	-	(115,000)
Cancelation of options	-	-	-	(255,000)
Exercise of warrants	496,500	-	(496,500)	-
Redemption of preferred shares	-	(1,000,000)	-	-
Balance - December 31, 2011	**116,607,057**	**-**	**8,955,500**	**11,353,800**
Grant of options				1,045,000
Expiry of options				(790,000)
Exercise of warrants	5,104,666	-	(5,104,666)	-
Expiry of warrants		-	(2,430,834)	-
Balance - Date of MD&A	**121,711,723**	**-**	**1,420,000**	**11,608,800**

Contingency

In December 2009, the Company terminated the Standstill Agreement that it had with an industry partner regarding a joint producing property and served that industry partner with a Statement of Claim issued from The Court of Queen's Bench of Alberta, by which the Company claims breach of the agreements between the parties, gross negligence and default of operator. The Company seeks judgment for specified and such further damages to be determined by the Court, as well as appointment as operator. The Company significantly increased the statement of claim based on the information provided by the defendant and expects the matter to go to trial during 2012. The potential outcome of the lawsuit and claims are undetermined, however, they may be material. As the likely outcome of this litigation cannot be determined at this time, no provision has been made in the consolidated financial statements.

Commitments

As at December 31, 2010, the Company had until December 31, 2011 to incur $9,690,000 of qualifying flow-through expenditures related to flow-through shares issued in March, May, June and October 2010 of which all required expenditures have been incurred. The Company has until December 31, 2012 to incur $10,000,000 of qualifying flow-through expenditures related to flow-through shares issued in June 2011. As at December 31, 2011 the company has approximately $6 million remaining to spend on the 2012 flow thorough commitment.

The Company has entered into lease agreements for office premises, field equipment and Company vehicles with estimated minimum annual payments as follows:

2012	$	185,571
2013	$	109,695

Financial instruments and financial risk management

The Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, bank debt, credit facility and preferred shares. The carrying values of accounts receivable, accounts payable and accrued liabilities, bank debt, credit facility and preferred shares approximate their fair values due to their relatively short periods to maturity.

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is as follows:

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

The fair value of cash and bank debt is level 1 it is determined using amounts held at/lent by financial institutions. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements. The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with the risk management policies as set out herein:

a. Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with natural gas and liquids marketers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's natural gas and liquids are subject to credit review to minimize the risk of non-payment. As at December 31, 2011, the maximum credit exposure is the carrying amount of the accounts receivable and accruals of $16,109,194 (December 31, 2010 – $3,752,477). As at December 31, 2011, the Company's receivables consisted of $14,007,979 from joint venture partners and other trade receivables and $2,101,216 of revenue receivable from petroleum and natural gas marketers.

Receivables from petroleum and natural gas marketers are typically collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any significant collection issues with its petroleum and natural gas marketers. All of the revenue accruals and receivables from petroleum and natural gas marketers were received in January and February 2012.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company mitigates the risk from joint venture receivables by obtaining partner approval of capital expenditures prior to starting a project. However, the receivables are from participants in the petroleum and natural gas sector, and collection is dependent on typical industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. Further risk exists with joint venture partners as disagreements occasionally arise which increases the potential for non-collection. For properties that are operated by the Company, production can be withheld from joint venture partners who are in default of amounts owing. In addition, the Company often has offsetting amounts payable to joint venture partners from which it can net receivable balances.

The Company did not provide for any doubtful accounts nor was it required to write-off any receivables during the three months ended December 31, 2011. The Company would only choose to write-off a receivable balance (as opposed to providing an allowance) after all reasonable avenues of collection had been exhausted.

As at December 31, 2011, the Company considers its receivables to be aged as follows:

Not past due	$	7,133,913
Past due by less than 90 days		5,398,582
Past due by more than 90 days		3,576,699
	$	16,109,194

b. Liquidity risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures.

To facilitate the capital expenditure program, the Company has a credit facility agreement which is regularly reviewed by the lender. The Company monitors its total debt position monthly. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month. The Company anticipates it will have adequate liquidity to fund its financial liabilities through its future cash flows. The Company's financial liabilities are comprised of accounts payable and accrued liabilities, bank debt and the credit facility, which have expected maturities of less than one year resulting in their current classification on the balance sheet.

c. Market risk

Market risk consists of interest rate risk, currency risk and commodity price risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks. All such transactions are conducted in accordance with a risk management policy as set out herein:

i. Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears interest at a floating rate. For the year ended December 31, 2011, if interest rates had been 1% lower with all other variables held constant, earnings for the year would have been $260,000 (2010 - $62,000) higher, due to lower interest expense. An equal and opposite impact would have occurred had interest rates been higher by the same amount. The Company had no interest rate swap or financial contracts in place at December 31, 2011.

ii. Currency risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. All of the Company's petroleum and natural gas sales are denominated in Canadian dollars, however, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Company had no outstanding forward exchange rate contracts in place at December 31, 2011.

iii. Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand as well as the relationship between the Canadian and United States dollar, as outlined above.

Capital disclosures

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute its capital expenditure program, which includes expenditures in oil and gas activities which may or may not be successful. Therefore, the Company monitors the level of risk incurred in its capital expenditures to balance the proportion of debt and equity in its capital structure.

The Company considers its capital structure to include shareholders equity:

	December 31, 2011	*December 31, 2010*
Shareholders' equity	$ 76,627,244	$ 47,835,896

The Company monitors capital based on annual funds from operations and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the Board of Directors.

The Company manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations such as quality and basis differentials, royalties, operating costs and transportation costs.

In order to maintain or adjust the capital structure, the Company considers its forecasted funds from operations while attempting to finance an acceptable capital expenditure program including acquisition opportunities, the current level of bank credit available from the Company's lender, the level of bank credit that may be attainable from its lender as a result of petroleum and natural gas reserve growth, the availability of other sources of debt with different characteristics than existing debt, the sale of assets, limiting the size of the capital expenditure program and the issue of new equity if available on favorable terms. At December 31 2011, the Company's capital structure was not subject to external restrictions.

Selected Historical Financial Information

	2011 Q4($)	2011 Q3($)	2011 Q2($)	2011 Q1($)
Petroleum and natural gas sales	**7,555,427**	5,378,932	4,283,356	3,524,544
Net petroleum and natural gas revenue	**7,327,783**	5,306,646	3,468,715	2,844,144
Net income (loss)	**(2,155,583)**	4,106,091	1,665,821	(2,230,631)
Net income (loss) per share – basic	**(0.02)**	0.04	0.02	(0.03)
Net income (loss) per share – diluted	**(0.02)**	0.03	0.01	(0.02)
Funds flow from operations	**5,686,411**	4,967,853	3,151,665	2,535,251
Funds flow from operations per share – basic	**0.05**	0.04	0.03	0.03
Funds flow from operations per share – fully diluted	**0.05**	0.04	0.03	0.03
Net capital expenditures	**19,735,557**	19,005,315	7,160,655	18,124,663

	2010 Q4($)	2010 Q3($)	2010 Q2($)	2010 Q1($)
Petroleum and natural gas sales	2,864,802	1,821,333	839,054	1,009,188
Net petroleum and natural gas revenue	2,017,879	1,299,935	439,729	646,831
Net loss	(183,574)	(228,916)	(1,185,541)	(147,119)
Net loss per share – basic	(0.00)	(0.00)	(0.02)	(0.00)
Net loss per share – diluted	(0.00)	(0.00)	(0.02)	(0.00)
Funds flow from operations	1,567,756	921,972	59,390	410,168
Funds flow from operations per share – basic	0.02	0.02	0.00	0.01
Funds flow from operations per share – fully diluted	0.02	0.02	0.00	0.01
Net capital expenditures	16,760,003	2,689,049	3,756,574	3,799,846

Business Risks and Uncertainties

The Company is exposed to several operational risks inherent in exploring, developing, producing and marketing crude oil and natural gas. These inherent risks include: economic risk of finding and producing reserves at a reasonable cost; financial risk of marketing reserves at an acceptable price given current market conditions; cost of capital risk associated with securing the needed capital to carry out the Company's operations; risk of environment impact; and credit risk of non-payment for sales contracts and joint venture partners.

The Company attempts to control operating risks by maintaining a disciplined approach to implementation of its exploration and development programs. Exploration risks are managed by hiring experienced technical professionals and by concentrating the exploration activity on specific core regions that have multi-zone potential where the Company has experience and expertise. The Company also generates internal prospects and participates in projects where ownership interest is considered sufficient to minimize risk. Operational control allows the Company to manage costs, timing and sales of production and to ensure new production is brought on-stream in a timely manner.

The Company maintains a comprehensive insurance program to reduce risk to an acceptable level and to protect it against significant losses.

Environmental Risks

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial and local laws and regulations. Compliance with such legislation can require significant expenditures and a breach could result in the imposition of fines and penalties, some of which could be material. Senior management continually assesses new and existing regulatory requirements and environmental risks and determines the impact these risks might have on the Company, as well as the appropriate actions necessary to manage those risks. These assessments and the resulting policy decisions are discussed quarterly with the Board of Directors which evaluates the performance and effectiveness of the Company's environmental policies and programs.

The Company's environmental responsibilities includes removing property, plant and equipment as well as reclaiming land and property to its original state, subsequent to the completion of oil and natural gas extraction activities. This requirement results in an asset retirement obligation that provides current recognition of estimated expenditures that will be incurred in the future. The Company's decommissioning liabilities are discussed in further detail under "Critical Accounting Estimates" below, as well as in note 6 to the Company's Condensed Interim Consolidated Financial Statements.

Disclosure Controls and Procedures

The Company's certifying officers will file a Venture Issuer Basic Certificate with respect to the information contained in its financial statements and respective accompanying Management's Discussion and Analysis. The Venture Issuer Basic Certification includes a 'Notice to Reader' stating that the certifying officers do not make any representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in National Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings.

Critical Accounting Estimates

The preparation of the financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect reported amounts and presentation of assets, liabilities, revenues, expenses and disclosures of contingencies and commitments. Such estimates primarily relate to unsettled transactions and events at the statement of financial position date which are based on information available to management at each financial statement date. Actual results could differ from those estimated.

Judgments, estimates and assumptions are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Property and equipment

The Company capitalizes costs in connection with the development of its oil and gas projects. The measurement of these costs at each financial statement date requires estimates to be made with respect to equipment and drilling activities. The estimate of the percentage of completion of various projects at the financial statement date affects P&E additions and the related accrued liability. An increase in the measurement amount of these items would increase P&E and accrued liabilities accordingly.

Reserves

Reserves and resources are used in the unit of production calculation for depletion and depreciation as well as impairment analysis. The quantity of reserves is subject to a number of estimates and projections including assessment of engineering data, projected future rates of production, commodity prices, regulatory changes, foreign exchange rates, operating costs and sustaining capital expenditures. These estimates and projections are uncertain as the Company does not have a long commercial production history to assist in the development of these forward-looking estimates. However, all reserve and associated financial information is evaluated and reported on by a firm of qualified independent reserve evaluators in accordance with the standards prescribed by applicable securities regulators.

The calculation of future cash flows based on these reserves is dependent on a number of estimates including: production volumes, facility performance, commodity prices, royalties, operating costs, sustaining capital, foreign exchange and tax rates. The price used in our assessment of future cash flows is based on the Company's independent evaluator's estimate of future prices and evaluated for reasonability by the Company against other available information. The Company believes these prices are reasonable estimates for a long-term outlook.

Impairment

The Company assesses its P&E and E&E assets for possible impairment if there are events or changes in circumstances that indicate the carrying values of the assets may not be recoverable. Such indicators include changes in the Company's business plans, changes in commodity prices, evidence of physical damage and significant downward revisions to estimated recoverable volumes or increases in estimated future development expenditures.

The assessment for impairment for P&E and E&E assets involves comparing the carrying value of the CGU with the higher of value in use calculations and fair value less costs to sell. Determination as to whether and how much an asset is impaired involves management estimates on highly uncertain matters such as future commodity prices, the effects of inflation on operating expenses, discount rates, production profiles and the outlook for regional supply-and-demand conditions for crude oil, natural gas and liquids. Impairment is recognized in earnings in the period in which carrying amount exceeded the recoverable amount. The Company has not recognized any impairment as at December 31, 2011.

Depletion and depreciation

Depletion of resource assets is measured over the life of proved and probable reserves on a unit-of-production basis and commences when the wells are substantially complete and after commercial production has begun. Reserve estimates and the associated future capital can have a significant impact on earnings, as these are key components to the calculation of depletion. A downward revision in the reserve estimate or an upward revision to future capital would result in increased depletion, reduced earnings and reduced carrying value of petroleum and natural gas property assets.

Decommissioning liabilities

The Company measures decommissioning liabilities at each financial statement date. The estimate is based on the Company's share of costs to reclaim the resource assets and certain facilities related to the projects as well as other resource assets associated with future expansions. To determine the future value of the liability, estimates of the amount, timing and inflation of the associated abandonment costs are made. The present value of the cost is recorded as the decommissioning liability using a risk-free discount rate. Due to the long-term nature of current and future project developments, abandonment costs will be incurred many years in the future. As a result of these factors, different estimates could be used for such abandonment costs and the associated timing. Assumptions of higher future abandonment costs, regulatory changes, higher inflation, lower risk-free rates or an assumption of earlier or specified timing of abandonment would cause the decommissioning liability of the corresponding asset to increase. These changes would also cause future accretion expenses to increase and future earnings to decrease.

Deferred taxes

Deferred income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. An estimate is required for both the timing and corresponding tax rate for this reversal. Should these estimates change, it may impact the measurement of the Company's assets or liabilities as well as deferred tax recovery or expense recognized to earnings. Where unfavorable evidence exists, additional considerations and evidence for recognition of deferred tax assets is required. The Company has applied management's judgment and evaluated applicable factors necessary in making this determination and has concluded that the positive evidence in consideration of the estimated future cash flows based on reserve reports from the Company's independent engineers, does not sufficiently outweigh negative factors. The Company only recognizes deferred tax assets arising from unused tax losses to the extent that the Company has sufficient taxable temporary differences or it is probable that sufficient taxable profit will be available against which the unused tax losses can be utilized. The Company has not recognized a deferred tax asset.

Contingencies

By their nature, contingencies will only be resolved when one or more of the future events occur or fail to occur. The assessment of contingencies inherently involves the exercise of significant judgment and estimates of the outcome of future events.

Other areas of estimates

The recognition of amounts in relation to stock-based compensation requires estimates related to valuation of stock options at the time of issuance. The fair value of foreign exchange contracts is calculated using valuation models that require estimates as to future market prices. By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements for current and future periods could be significant.

International Financial Reporting Standards ("IFRS")

Effective January 1, 2011, International Financial Reporting Standards ("IFRS") have replaced Canadian GAAP for publicly accountable enterprises. The Company has adopted IFRS for the interim and annual periods beginning on January 1, 2011, including comparative information pertaining to 2010.

Information regarding the Company's accounting policies and transition to IFRS can be found in notes 1, 2 and 18 to the Condensed Interim Consolidated Financial Statements. Significant items to note upon transition include:

Depletion and depreciation

Under IFRS, depletion of P&E properties is calculated at a unit-of-account level using proved and probable reserves as the basis, as opposed to using only proved reserves as was required practice under Canadian GAAP. This has resulted in significantly lower depletion under IFRS than under Canadian GAAP.

Decommissioning liabilities

Under IFRS, the assumptions used in calculating asset retirement obligations are to be analyzed at each balance sheet date and updated to reflect current market conditions when appropriate. Due to the change recorded on January 1, 2010, resulting from the use of the risk-free rate as opposed to the credit-adjusted risk-free rate, the amount of accretion recorded under IFRS is lower than that recorded under Canadian GAAP. In addition, the Company has chosen to show accretion separately on its financial statements as opposed to including with depletion and depreciation, as was common practice under Canadian GAAP.

Transition adjustments

At January 1, 2010, the assumptions used to calculate the decommissioning liabilities were altered to reflect current market conditions, as required under IFRS. The change resulted in an increase to the liability of $755,065.

Flow-through Shares

Flow-through shares are a Canadian tax incentive which is the subject of specific guidance under Canadian GAAP, however there is no specific guidance under IFRS. Under Canadian GAAP, when flow-through shares are issued they are recorded at face value. The related future tax liability is established for the tax effect of the difference between the tax basis and the book basis of the assets when renounced and is recorded as a reduction of share capital. There is no income statement effect associated with the issuance of these shares.

The Company has adopted a policy under IFRS where the proceeds from the offering are to be allocated between the sale of the shares and the sale of the tax benefit. The allocation is made based on the difference between the quoted market price of the existing shares and the amount an investor pays for the flow-through shares. A liability is established for this difference that is reversed upon renunciation of the tax benefit. The difference between this liability and the deferred tax liability is recorded as an income tax expense. This has resulted in a re-classification between deficit and share capital at January 1, 2010 of $4,047,525.

Yangarra Resources Ltd.

Consolidated Financial Statements

December 31, 2011 and 2010

Management's Responsibility

To the Shareholders of Yangarra Resources Ltd.:

Management is responsible for the preparation and presentation of the accompanying consolidated financial statements, including responsibility for significant accounting judgments and estimates in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and ensuring that all information in the annual report is consistent with the statements. This responsibility includes selecting appropriate accounting principles and methods, and making decisions affecting the measurement of transactions in which objective judgment is required.

In discharging its responsibilities for the integrity and fairness of the financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of financial statements.

The Board of Directors exercises its responsibilities for financial controls through an Audit Committee. The Audit Committee is responsible for overseeing management in the performance of its financial reporting responsibilities, and for approving the financial information included in the annual report. The Committee has the responsibility of meeting with management and external auditors to discuss the internal controls over the financial reporting process, auditing matters and financial reporting issues. The Committee is also responsible for recommending the appointment of the Company's external auditors.

MNP LLP, an independent firm of Chartered Accountants, is appointed by the shareholders to audit the financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically and separately with, both the Audit Committee and management to discuss their audit findings.

April 4, 2012

"James G. Evaskevich" (signed)
James G. Evaskevich
Chief Executive Officer

"James A. Glessing" (signed)
James A. Glessing
Chief Financial Officer

Auditors' Report

To the Shareholders of Yangarra Resources Ltd.:

We have audited the consolidated financial statements of Yangarra Resources Ltd. and its subsidiary which comprise the consolidated statements of financial position as at December 31, 2011, December 31, 2010 and January 1, 2010, the consolidated statements comprehensive income (loss), changes in equity and cash flows for the years ended December 31, 2011 and December 31, 2010, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Yangarra Resources Ltd. and its subsidiary as at December 31, 2011, December 31, 2010 and January 1, 2010, and their financial performance and their cash flows for the years ended December 31, 2011 and December 31, 2010 are in accordance with International Financial Reporting Standards.

Calgary, Canada
April 4, 2012

MNP LLP
Chartered Accountants

Yangarra Resources Ltd.
Consolidated Statements of Financial Position
As at:

	December 31, 2011	December 31, 2010 *(note 18)*	January 1, 2010 *(note 18)*
Assets			
Current			
Cash and cash equivalents	$ –	$ 11,678	$ –
Accounts receivable *(note 14)*	**16,109,194**	3,752,477	658,080
Prepaid expenses and deposits	**1,318,702**	243,214	152,853
Assets held for sale *(note 3)*	**463,100**	463,100	–
Total current assets	**17,890,996**	4,470,469	810,933
Non-current			
Property and equipment *(note 3)*	**119,374,219**	63,263,452	37,624,049
Exploration and evaluation assets *(note 4)*	**4,025,828**	639,892	1,206,467
Total assets	$ **141,291,043**	$ 68,373,813	$ 39,641,449
Liabilities			
Current			
Bank debt *(note 5)*	$ **26,245,533**	$ 5,559,208	$ 8,195,069
Accounts payable and accrued liabilities	**25,673,625**	9,383,722	465,554
Preferred shares *(note 7)*	–	1,000,000	1,000,000
Commodity contract *(note 14c iii)*	**1,491,875**	–	113,361
Flow-through share premium liability *(note 7)*	**1,500,000**	1,093,182	–
Total current liabilities	**54,911,033**	17,036,112	9,773,984
Non-current			
Other long-term debt	**410,000**	–	–
Decommissioning liability *(note 6)*	**4,898,222**	3,501,805	2,936,792
Deferred tax liability *(note 11)*	**4,444,544**	–	837,357
Total liabilities	**64,663,799**	20,537,917	13,548,133
Shareholders' Equity			
Share capital *(note 7)*	**90,895,319**	65,909,948	47,066,815
Warrants *(note 9)*	**2,116,564**	2,216,541	340,600
Contributed surplus	**8,261,009**	5,740,753	2,972,097
Deficit	**(24,645,648)**	(26,031,346)	(24,286,196)
Total shareholders' equity	**76,627,244**	47,835,896	26,093,316
Total liabilities and equity	$ **141,291,043**	$ 68,373,813	$ 39,641,449

Contingency (*note 16), Commitments (note 17)*

Approved on behalf of the Board of Directors

"James G. Evaskevich" (signed)
James G. Evaskevich

"Gordon A. Bowerman" (signed)
Gordon A. Bowerman

The accompanying notes are an integral part of these consolidated financial statements

		2011		2010 *(note 18)*
Revenue				
Petroleum and natural gas sales	$	**20,742,259**	$	6,534,377
Royalty income		**613,139**		123,106
Royalties paid		**(972,706)**		(165,309)
		20,382,692		6,492,174
Commodity price risk contracts *(note 14)*				
Commodity contract settlement		**1,269,687**		40,734
Change in fair value of commodity contracts		**(1,491,875)**		113,361
		20,160,504		6,646,269
Expenses				
Production		**3,248,011**		1,820,683
Transportation		**348,431**		237,893
General and administrative		**1,374,170**		1,161,575
Finance		**330,107**		441,879
Share-based compensation *(note 8)*		**1,682,583**		1,746,939
Depletion and depreciation *(note 3*)		**8,304,505**		3,811,668
Other expenses		–		25,129
		15,287,807		9,245,766
Income (loss) before income tax		**4,872,697**		(2,599,497)
Deferred tax *(note 11)*		**3,486,999**		(854,347)
Total comprehensive income (loss) for the period attributable to common shareholders	$	**1,385,698**	$	(1,745,150)
Net income (loss) per share *(note 10)*				
Basic	$	**0.01**	$	(0.03)
Diluted	$	**0.01**	$	(0.03)
Weighted average number of shares *(note 10)*				
Basic		**105,960,324**		57,581,832
Diluted		**113,781,122**		57,581,832

		2011		2010 *(note 18)*
Share Capital				
Balance, beginning of period	$	**65,909,948**	$	47,066,815
Issued		**25,751,725**		19,765,518
Share issue costs (net of tax)		**(1,438,625)**		(1,394,688)
Exercise of warrants		**348,227**		388,359
Exercise of options		**324,044**		83,944
Balance, end of period		**90,895,319**		65,909,948
Warrants				
Balance, beginning of period		**2,216,541**		340,600
Issued		**–**		1,990,300
Exercised		**(99,977)**		(114,359)
Balance, end of period		**2,116,564**		2,216,541
Contributed Surplus				
Balance, beginning of period		**5,740,753**		2,972,097
Share-based compensation related to:				
Options granted in current year		**2,714,300**		2,817,600
Exercised options		**(194,044)**		(48,944)
Balance, end of period		**8,261,009**		5,740,753
Deficit				
Balance, beginning of period		**(26,031,346)**		(24,286,196)
Total comprehensive income (loss)		**1,385,698**		(1,745,150)
Balance, end of period		**(24,645,648)**		(26,031,346)
Total Equity	$	**76,627,244**	$	47,835,896

The accompanying notes are an integral part of these consolidated financial statements

		2011		2010 *(note 18)*
Operating				
Total comprehensive income (loss) for the period	$	**1,385,698**	$	(1,745,150)
Add back non-cash items:				
Change in fair value of commodity contracts		**1,491,875**		(113,361)
Share-based compensation *(note 8)*		**1,682,583**		1,746,939
Depletion and depreciation *(note 3)*		**8,304,505**		3,811,668
Net financing expenses (including accretion)		**107,281**		126,628
Deferred tax		**3,486,999**		(854,347)
Gain on abandonment expenditures		**(117,761)**		(13,091)
		16,341,180		2,959,286
Change in non-cash working capital *(note 12)*		**(9,676,331)**		(2,863,908)
		6,664,849		95,378
Financing				
Issue of equity instruments, net of issue costs		**25,711,807**		21,423,415
Redemption of preferred shares *(note 7)*		**(1,000,000)**		–
Proceeds from other long-term debt		**410,000**		–
Proceeds from bank debt, net		**20,686,325**		(2,635,861)
Change in non-cash working capital *(note 12)*		–		190,988
		45,808,132		18,978,542
Investing				
Expenditures on property and equipment		**(60,640,254)**		(26,945,966)
Expenditures on exploration and evaluation assets		**(3,385,936)**		–
Expenditures on other assets		**(992,498)**		(59,308)
Change in non-cash working capital *(note 12)*		**12,534,029**		7,943,230
		(52,484,659)		(19,062,242)
Change in cash		**(11,678)**		11,678
Cash, beginning of the period		**11,678**		–
Cash, end of the period	$	**–**	$	11,678
Supplemental cash flow information				
Interest paid	$	**213,866**	$	265,251
Dividends paid	$	**8,960**	$	25,000

The accompanying notes are an integral part of these consolidated financial statements

1. Basis of preparation, adoption of IFRS and statement of compliance

Yangarra Resources Ltd. (the "Company") is a publicly traded company involved in the production, exploration and development of resource properties in Western Canada. The address of the registered office is 1530, 715 – 5 Avenue SW, Calgary Alberta, T2P 2X6.

On May 1, 2010, the Company and its wholly owned subsidiary Athabaska Energy Ltd. ("Athabaska") were amalgamated and continue to carry on business under the name Yangarra Resources Ltd. At that time, the Company consolidated its common shares on a five old for one new (5:1) basis. All common share, warrant and stock option figures disclosed herein are presented on a consolidated basis.

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Yangarra Resources Corp. ("YRC"), after the elimination of intercompany transactions and balances.

These consolidated financial statements, including comparatives, have been prepared in accordance with International Financial Reporting Standards ("IFRS") and IFRS 1 "First-time Adoption of IFRS". The disclosures regarding the transition to IFRS are included in note 18, which includes the impact on the Company's reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in the Company's financial statements for the year ended December 31, 2010. Subject to certain transition elections taken and disclosed in note 18, the Company has consistently applied the same accounting policies in its opening IFRS balance sheet at January 1, 2010 and throughout all periods presented, as if these policies had always been in effect. The Company previously prepared its annual consolidated financial statements under Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants (Canadian GAAP). In these consolidated financial statements, the term "Canadian GAAP" refers to Canadian GAAP before the adoption of IFRS.

The policies applied in these consolidated financial statements are based on IFRS issued and outstanding as of April 4, 2012, the date the Board of Directors approved the statements. Any subsequent changes to IFRS that are given effect to the Company's annual financial statements for the year ended December 31, 2011 could result in restatement of these financial statements, including the transition adjustments described in note 18.

Note 18 discloses information on the transition to IFRS effective for the year ended December 31, 2010 that is material to the understanding of these financial statements.

2. Summary of significant accounting policies

a) Basis of measurement

The consolidated financial statements have been prepared under the historical cost method, except for the revaluation of certain financial assets and financial liabilities to fair value, including derivative instruments and share-based payments.

2. Summary of significant accounting policies (continued)

b) Cash and cash equivalents

Cash consists of bank balances.

c) Property and equipment and exploration and evaluation assets

(i) Exploration and evaluation assets

Exploration and evaluation ("E&E") assets include land acquisition costs, geological and geophysical costs, exploratory drilling, directly attributable expenses and activities relating to evaluating the technical feasibility and commercial viability of the Company's resources.

E&E costs are capitalized and are amortized over the assets life until such time as the exploration phase is complete and technical feasibility and commercial viability of extracting the mineral resource has been demonstrated. Technical feasibility and commercial viability is demonstrated when proven reserves are determined to exist along with sanctioning of a project by the Company's Board of Directors. Once demonstrated, E&E assets are tested for impairment in accordance with IAS 36 "Impairment of Assets" ("IAS 36") and transferred to property and equipment (P&E), and further development costs are capitalized to P&E. E&E assets are also tested for impairment in accordance with IAS 36 if facts and circumstances suggest that the carrying amount exceeds the recoverable amount. If it is determined that technical feasibility and commercial viability has not been achieved in relation to a property, the resulting loss is included in the statement of comprehensive income (loss).

Pre-license costs, defined as those costs incurred before the legal right to explore has been acquired, are expensed in the period in which they are incurred. Exploration and evaluation costs of a type that are not sufficiently closely related to a specific mineral resource to support capitalization are also expensed in the period in which they are incurred.

(ii) Property and equipment

Property and equipment (P&E) are carried at cost, less accumulated depletion, depreciation and accumulated impairment losses. The cost of an item of P&E consists of the purchase price, any costs directly attributable to bringing the asset into the location and condition necessary for its intended use, a discounted current estimate of the decommissioning costs and borrowing costs for qualifying assets.

Oil and gas capitalized costs are depleted using the unit-of-production method. Depletion is calculated using the ratio of production in the year to the remaining total proved and probable reserves before royalties, taking into account future development costs prior to inflation necessary to bring those reserves into production. These estimates are evaluated and reported on by independent reserve engineers annually. Proven and probable reserves are estimated using independent reserve engineer reports. There is a 50 percent estimated statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as proven and probable. The statistical probability for proven reserves is 90 percent.

2. Summary of significant accounting policies (continued)

Where an item of P&E comprises major components with different useful lives, the components are accounted for as separate items of P&E. The expected useful lives of P&E, residual values and methods of depreciation are reviewed at each reporting period and, if necessary, changes are accounted for prospectively.

Changes in estimates such as quantities of proved and probable reserves that affect unit-of-production calculations are applied on a prospective basis.

An item of P&E is derecognized upon disposal or is impaired when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss on disposal of the asset, determined as the difference between the net proceeds and the carrying amount of the asset, is recognized in the statement of comprehensive income (loss) in the period incurred.

The carrying amounts of property and equipment are reviewed for impairment when indicators of such impairment exist. If indicators exist, the assets are tested for impairment under IAS 36.

(iii) Impairment of non-financial assets under IAS 36

At each financial reporting date, the carrying amounts of property and equipment are reviewed to determine whether there is any indication that those assets are impaired. If such indication exists, an estimate of the recoverable amount of the asset is calculated.

Individual assets are grouped together for impairment assessment purposes into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the cash generating unit or CGU). The carrying amount of P&E assets within a CGU are compared to the recoverable amount of the CGU. Goodwill is allocated to CGUs that are expected to benefit from synergies of the combination. E&E assets are allocated to CGUs when they are assessed for impairment if indicators of impairment exist as well as upon their reclassification into P&E.

A CGU's recoverable amount is the higher of its fair value less costs to sell and its value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money to the Company and the risks specific to the asset. Fair value less cost to sell is derived by estimating the discounted after-tax future net cash flows. Discounted future net cash flows are based on forecasted commodity prices and costs over the expected economic life of the reserves and discounted market-based rates to reflect a market participants view of the risks associated with the assets.

Where the carrying amount of a CGU exceeds its recoverable amount, the CGU is considered impaired and is written down to its recoverable amount. The impairment loss is charged to the statement comprehensive income (loss). A previously recognized impairment loss is reversed or partially reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognized. If that is the case, the carrying amount of the asset is increased to its recoverable amount. The new carrying amount cannot exceed the carrying amount that would have been determined, net of depletion and depreciation, had no impairment loss been recognized for the asset in prior periods.

2. Summary of significant accounting policies (continued)

(iv) Decommissioning liability

The Company recognizes a decommissioning liability in the period it arose with a corresponding increase to the carrying amount of the related asset. Measurement occurs when a legal or constructive obligation arises. Provisions are measured at the present value of the expenditures expected to be required to settle the obligation discounted using the pre-tax risk-free rate, updated at each reporting date. The increase in the provision due to the passage of time (accretion) is recognized as a finance expense whereas increases or decreases due to changes in the estimated cost to decommission the asset are capitalized as P&E. Actual costs incurred upon settlement of the decommissioning liability reduce the liability to the extent the provision was established. The related decommissioning asset is depreciated or depleted on the same basis as the P&E to which it relates.

(v) Corporate assets

Corporate assets are recorded at cost less accumulated amortization, which is calculated using the declining balance method at rates of 20 percent to 30 percent per annum.

(vi) Maintenance and turnarounds

Expenditures associated with maintenance activities or major turnarounds that improve the productive capacity or extend the life of an asset are capitalized. These costs are included in P&E when incurred and charged to depletion and depreciation over the estimated useful life. Any remaining carrying amounts of any replaced or sold components are derecognized. Maintenance and repairs, other than major turnaround costs, are expensed as incurred.

d) Leases

Leases that transfer substantively all the benefits, risks and rewards of ownership to the Company are recorded as finance leases. Finance leases are capitalized at the lease's commencement at the lower of the fair value of the leased asset and the present value of the minimum lease payments with a corresponding increase to obligations under finance leases. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the obligation outstanding. The finance charge is included in the statement of comprehensive income (loss) over the lease period.

Leases that do not transfer the risks and rewards of ownership to the Company are classified as operating leases under which leasing costs are expensed in the period incurred.

e) Joint venture operations

A portion of the Company's petroleum and natural gas exploration and production activities are conducted jointly with others, and, accordingly, these consolidated financial statements reflect only the Company's proportionate interest in such activities.

f) Share capital

Common shares are classified as equity on the statement of financial position. Transaction costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any tax effects.

2. Summary of significant accounting policies (continued)

g) Revenue recognition

Revenue is recognized from oil sales when the oil is delivered to the buyer and from gas sales when the gas passes through the pipeline at the delivery point.

h) Transportation

The Company is contractually obligated to pay to transport on the Company's share of oil and gas products sold to the nearest market terminal. These costs are presented in the statement of operations, loss and comprehensive loss as transportation expense.

i) Income taxes

Income tax expense represents the sum of current tax expense and deferred tax expense. Current tax expense is based on the taxable profits for the year. Income tax is recognized in the statement comprehensive income (loss) except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax expense is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax assets and liabilities are recognized based on differences in the financial statement carrying amount for assets and liabilities and the associated tax balance. Deferred tax liabilities are generally recognized for all taxable temporary differences. Deferred tax assets are generally recognized for all deductible temporary differences, unused tax credits carried forward and unused tax losses to the extent that it is probable that there will be taxable profits against which deductible temporary differences can be utilized.

Deferred taxes are measured based on enacted or substantively enacted tax rates for the period in which the temporary differences are expected to be realized or settled, and are presented as non-current.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities, when they relate to income taxes levied by the same taxation authority and when the Company intends to settle its current tax assets and liabilities on a net basis.

j) Flow-through shares

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through equity instruments are renounced to investors in accordance with income tax legislation. The proceeds from issuance are allocated between the offering of shares and the sale of tax benefits. The allocation is made based on the difference between the quoted price of the existing shares and the amount the investor pays for the shares. A liability is recognized for this difference. The liability is reversed when tax benefits are renounced and a deferred tax liability is recognized at that time. Income tax expense is the difference between the amount of the deferred tax liability and the liability recognized on issuance.

2. Summary of significant accounting policies (continued)

k) Share-based compensation plans

Stock options granted to directors, officers, employees and consultants are accounted for using the fair value method under which compensation expense is recorded based on the estimated fair value of the options at the grant date using the Black-Scholes option pricing model. Each tranche in an award is considered a separate award with its own vesting period and grant date fair value. Compensation cost is either expensed or capitalized depending upon whether or not the individual to which the award relates is directly related to the development of its oil and gas projects, over the vesting period with a corresponding increase in contributed surplus. When stock options are exercised, the cash proceeds along with the amount previously recorded as contributed surplus are recorded as share capital. The number of awards expected to vest is reviewed annually. The Company does not incorporate forfeitures into the Black-Scholes option pricing model as all options granted vest immediately.

l) Earnings per share

Basic earnings per share ("EPS") is calculated by dividing the net income (loss) for the period attributable to equity owners of the Company by the weighted average number of common shares outstanding during the period. Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The Company's potentially dilutive instruments are comprised of stock options granted and warrants granted.

m) Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantively all the risks and rewards of ownership.

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instrument were acquired.

(i) Fair value through profit or loss

A financial asset can be classified as fair value asset through profit or loss only if it is designated at fair value through profit or loss or held-for-trading. Held-for-trading assets are comprised of derivatives or assets acquired or incurred principally for the purpose of selling or repurchasing in the near term. The Company's commodity contracts are derivatives and are recorded at fair value with changes in fair value included in profit or loss. The Company does not apply hedge accounting to its derivative instruments.

2. Summary of significant accounting policies (continued)

(ii) Held-to-maturity

These assets are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Company has the positive intention and ability to hold until maturity. These assets are measured at amortized cost using the effective interest method. If there is objective evidence that the investment is impaired, impairment losses are included in profit or loss.

(iii) Loans and receivables

These assets are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. These assets are measured at amortized cost using the effective interest method. Any gains or losses on the realization of receivables are included in profit or loss.

iv) Other financial liabilities

Other financial liabilities are measured at amortized cost using the effective interest method. Any gains or losses in the realization of other financial liabilities are included in profit or loss.

Impairment of financial assets

All financial assets except for those at fair value through profit or loss are subject to review for impairment at each reporting date. Financial assets are impaired when there is any objective evidence that a financial asset or a group of financial assets are impaired. Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized.

Fair values

Fair values of financial assets and liabilities are based upon quoted market prices available from active markets or are otherwise determined using a variety of valuation techniques and models using quoted market prices.

Borrowing costs

Borrowing costs that are directly related to the issuance of new debt are recorded net of the associated debt and recognized into income using the effective interest rate method over the life of the debt.

Discounts on issuance of new debt

Discounts, where proceeds received are less than the par value of the debt, are recorded as a reduction to long-term debt. These discounts would be amortized using the effective interest method and included in finance expense.

2. Summary of significant accounting policies (continued)

n) Significant accounting judgments and estimates

The preparation of the consolidated financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect reported amounts and presentation of assets, liabilities, revenues, expenses and disclosures of contingencies and commitments. Such estimates primarily relate to unsettled transactions and events at the statement of financial position date which are based on information available to management at each financial statement date. Actual results could differ from those estimated.

Judgments, estimates and assumptions are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Property and equipment

The Company capitalizes costs in connection with the development of its oil and gas projects. The measurement of these costs at each financial statement date requires estimates to be made with respect to equipment and drilling activities. The estimate of the percentage of completion of various projects at the financial statement date affects P&E additions and the related accrued liability. An increase in the measurement amount of these items would increase P&E and accrued liabilities accordingly.

Reserves

Reserves and resources are used in the unit of production calculation for depletion and depreciation as well as impairment analysis. The quantity of reserves is subject to a number of estimates and projections including assessment of engineering data, projected future rates of production, commodity prices, regulatory changes, foreign exchange rates, operating costs and sustaining capital expenditures. These estimates and projections are uncertain as the Company does not have a long commercial production history to assist in the development of these forward-looking estimates. However, all reserve and associated financial information is evaluated and reported on by a firm of qualified independent reserve evaluators in accordance with the standards prescribed by applicable securities regulators.

The calculation of future cash flows based on these reserves is dependent on a number of estimates including: production volumes, facility performance, commodity prices, and royalties, operating costs, sustaining capital, foreign exchange and tax rates. The price used in the Company's assessment of future cash flows is based on the Company's independent evaluator's estimate of future prices and evaluated for reasonability by the Company against other available information. The Company believes these prices are reasonable estimates for a long-term outlook.

Impairment

The Company assesses its P&E and E&E assets for possible impairment if there are events or changes in circumstances that indicate the carrying values of the assets may not be recoverable. Such indicators include changes in the Company's business plans, changes in commodity prices, evidence of physical damage and significant downward revisions to estimated recoverable volumes or increases in estimated future development expenditures.

2. Summary of significant accounting policies (continued)

The assessment for impairment for P&E and E&E assets involves comparing the carrying value of the CGU with the higher of value in use calculations and fair value less costs to sell. Determination as to whether and how much an asset is impaired involves management estimates on highly uncertain matters such as future commodity prices, the effects of inflation on operating expenses, discount rates, production profiles and the outlook for regional supply-and-demand conditions for crude oil, natural gas and liquids. Impairment is recognized in earnings in the period in which carrying amount exceeded the recoverable amount.

Depletion and depreciation

Depletion of resource assets is measured over the life of proved and probable reserves on a unit-of-production basis and commences when the wells are substantively complete and after commercial production has begun. Reserve estimates and the associated future capital can have a significant impact on earnings, as these are key components to the calculation of depletion. A downward revision in the reserve estimate or an upward revision to future capital would result in increased depletion, reduced earnings and reduced carrying value of petroleum and natural gas property assets.

Decommissioning liabilities

The Company measures decommissioning liabilities at each financial statement date. The estimate is based on the Company's share of costs to reclaim the resource assets and certain facilities related to the projects as well as other resource assets associated with future expansions. To determine the future value of the liability, estimates of the amount, timing and inflation of the associated abandonment costs are made. The present value of the cost is recorded as the decommissioning liability using a risk-free discount rate. Due to the long-term nature of current and future project developments, abandonment costs will be incurred many years in the future. As a result of these factors, different estimates could be used for such abandonment costs and the associated timing. Assumptions of higher future abandonment costs, regulatory changes, higher inflation, lower risk-free rates or an assumption of earlier or specified timing of abandonment would cause the decommissioning liability of the corresponding asset to increase. These changes would also cause future accretion expenses to increase and future earnings to decrease.

Deferred taxes

Deferred income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. An estimate is required for both the timing and corresponding tax rate for this reversal. Should these estimates change, it may impact the measurement of the Company's assets or liabilities as well as deferred tax recovery or expense recognized to earnings. Where unfavorable evidence exists, additional considerations and evidence for recognition of deferred tax assets is required. The Company has applied management's judgment and evaluated applicable factors necessary in making this determination and has concluded that the positive evidence in consideration of the estimated future cash flows based on reserve reports from the Company's independent engineers, does not sufficiently outweigh negative factors. The Company only recognizes deferred tax assets arising from unused tax losses to the extent that the Company has sufficient taxable temporary differences or it is probable that sufficient taxable profit will be available against which the unused tax losses can be utilized.

2. Summary of significant accounting policies (continued)

Contingencies

By their nature, contingencies will only be resolved when one or more of the future events occur or fail to occur. The assessment of contingencies inherently involves the exercise of significant judgment and estimates of the outcome of future events.

Other areas of estimates

The recognition of amounts in relation to stock-based compensation requires estimates related to valuation of stock options at the time of issuance. The fair value of foreign exchange contracts is calculated using valuation models that require estimates as to future market prices. By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements for current and future periods could be significant.

o) Accounting standards issued but not yet applied

Certain new standards, interpretations, amendments and improvements to existing standards were issued by the IASB or International Financial Reporting Interpretations Committee ("IFRIC") that are mandatory for accounting periods beginning after January 1, 2012 or later periods. The standards impacted that are applicable to the Company are as follows:

IFRS 9, 'Financial Instruments' was issued in November 2009 as the first step in its project to replace IAS 39 'Financial Instruments: Recognition and Measurement'. IFRS 9 introduces new requirements for classifying and measuring financial assets that must be applied starting January 1, 2013, with early adoption permitted. The IASB intends to expand IFRS 9 during the intervening period to add new requirements for classifying and measuring financial liabilities, de-recognition of financial instruments, impairment and hedge accounting. The Company is currently assessing the impact of this standard.

IFRS 10, 'Consolidated Financial Statements' was issued in May 2011 and will supersede the consolidation requirements in SIC-12 'Consolidation – Special Purpose Entities' and IAS 27 'Consolidated and Separate Financial Statements' effective for annual periods beginning on or after January 1, 2013, with early application permitted. IFRS 10 builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. The standard also provides additional guidance to assist in the determination of control where this is difficult to assess. The Company is currently assessing the impact of this standard.

IFRS 11, 'Joint Arrangements' was issued in May 2011 and will supersede existing IAS 31, 'Joint Ventures' effective for annual period beginning on or after January 1, 2013, with early application permitted. IFRS 11 provides for the accounting of joint arrangements by focusing on the rights and obligations of the arrangement, rather than its legal form (as is currently the case). The standard also eliminates the option to account for jointly controlled entities using the proportionate consolidation method. The Company is currently assessing the impact of this standard.

IFRS 12, 'Disclosure of Interests in Other Entities' was issued in May 2011 and is a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. The Company is currently assessing the impact of this standard.

2. Summary of significant accounting policies (continued)

IFRS 13, 'Fair Value Measurement' was issued in May 2011 and sets out in a single IFRS a framework for measuring fair value. IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This definition of fair value emphasizes that fair value is a market-based measurement, not an entity-specific measurement. In addition, IFRS 13 also requires specific disclosures about fair value measurement. IFRS 13 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. The Company is currently assessing the impact of this standard.

IAS 1, 'Presentation of Items of Other Comprehensive Income' – In 2011, the IASB issued amendments to IAS 1 Presentation of Financial Statements to split items of other comprehensive income (OCI) between those that are reclassified to income and those that are not. The standard is required to be adopted for periods beginning on or after July 1, 2012.

IAS 27, 'Separate Financial Statements' – The IASB issued amendments to IAS 27 Separate Financial Statements to coincide with the changes made in IFRS 10, but retains the current guidance for separate financial statements.

IAS 28, 'Investments in Associates and Joint Ventures' – The IASB issued amendments to IAS 28 Investments in Associates and Joint Ventures to coincide with the changes made in IFRS 10 and IFRS 11.

3. Property and equipment

	Oil and Natural Gas Interests	*Well and plant equipment*	*Head Office*	*Total*
Cost or Deemed Cost				
Balance at January 1, 2010	$ 26,213,578	$ 11,334,327	$ 76,144	$ 37,624,049
Additions	24,444,623	4,213,570	59,308	28,717,501
Acquisitions	2,959,691	156,502	–	3,116,193
Balance at December 31, 2010	53,617,892	15,704,399	135,452	69,457,743
Additions	**53,935,149**	**9,487,625**	**992,498**	**64,415,272**
Balance at December 31, 2011	**$ 107,553,041**	**$ 25,192,024**	**$ 1,127,950**	**$ 133,873,015**
Depletion, depreciation and impairment losses				
Balance at January 1, 2010	$ –	$ –	$ –	$ –
Depletion and depreciation	3,251,822	537,500	22,346	3,811,668
Impairment loss	2,382,623	–	–	2,382,623
Balance at December 31, 2010	5,634,445	537,500	22,346	6,194,291
Depletion and depreciation	**7,256,900**	**938,000**	**109,605**	**8,304,505**
Balance at December 31, 2011	**$ 12,891,345**	**$ 1,475,500**	**$ 82,451**	**$ 14,498,796**

3. Property and equipment(continued)

Net book amount				
At December 31, 2011	**$ 94,661,696**	**$ 23,716,524**	**$ 995,999**	**$ 119,374,219**
At December 31, 2010	$ 47,983,447	$ 15,166,899	$ 113,106	$ 63,263,452
At January 1, 2010	$ 26,213,578	$ 11,334,327	$ 76,144	$ 37,624,049

The depletion, depreciation and impairment of property and equipment, and any eventual reversal thereof, are recognized in depletion, depreciation and amortization in the statement of comprehensive income (loss). Future development costs of 62,410,000 (2010 – 58,717,500) are included in the depletion calculation. At December 31, 2011 all of the Company's properties are pledged as security for the bank loans.

During year ended December 31, 2011, the Company capitalized $652,382 (2010 – $438,385) related to the decommissioning liability of property and equipment and $1,375,622 (2010 – $475,145) of stock based compensation. The Company also capitalized $718,809 (2010 – $193,420) of general and administrative costs as well as $755,658 (2010 - $147,258) of recoveries related to the Company's working interest in operated capital expenditure programs on which operator's fees have been charged in accordance with standard industry operating agreements.

As at December 31, 2011, property and equipment totaling $463,100 (2010 – $463,100) was classified as a current asset held for sale as the Company intends to recover the carrying amount principally through a sale transaction rather than through continuing use in the next twelve months. The current asset classified as held for sale was measured at the lower of its carrying amount and fair value less costs to sell.

The Company performed impairment test calculations at December 31, 2011 to assess whether the carrying value of the petroleum and natural gas properties were recoverable. No impairment was recorded in 2011 (2010 - $2,382,623). The following represent the prices that were used in the December 31, 2011 impairment tests:

Average Price Forecast

Year	***WTI Cushing* 40° API**	***Alberta AECO-C Spot***	***Exchange Rate***
2012	100.00	3.50	1.00
2013	102.00	4.10	1.00
2014	104.50	4.70	1.00
2015	106.10	5.15	1.00
2016	108.25	5.55	1.00
2017	110.40	6.00	1.00
2018	112.60	6.40	1.00
2019	114.85	6.90	1.00
2020	117.15	7.40	1.00
2021	119.50	7.75	1.00

Escalation rate of 2.0% thereafter

The benchmark prices listed above are adjusted for quality differentials, heat content, distance to market and other factors in performing the ceiling test. Percentage change represents the change in each year after 2021 to the end of the reserve life.

4. Exploration and evaluation assets

Cost or Deemed Cost		
Balance at January 1, 2010	$	5,005,176
Additions		–
Balance at December 31, 2010		5,005,176
Additions		**3,385,939**
Balance at December 31, 2011	**$**	**8,391,115**
Depletion, depreciation and impairment losses		
Balance at January 1, 2010	$	3,798712
Amortization		566,575
Balance at December 31, 2010		4,365,287
Amortization		–
Balance at December 31, 2011	**$**	**4,365,287**
Net book Value		
At December 31, 2011	**$**	**4,025,828**
At December 31, 2010	$	639,892
At January 1, 2010	$	1,206,467

Exploration and evaluation ("E&E") assets consist of the Company's exploration projects which are pending the determination of proven or probable reserves. Additions represent the Company's share of costs incurred on E&E assets during the period.

(a) Amortization and impairment charge

The impairment of intangible exploration assets, and any eventual reversal thereof, is recognized as additional depletion and depreciation expense in the statement of comprehensive income. The impairment of other intangible assets and goodwill, and any eventual reversal thereof (excluding goodwill), is recognized as amortization expense in the income statement.

(b) Recoverability of exploration and evaluation assets

The Company assesses the recoverability of E&E assets, before and at the moment of reclassification to property and equipment, using CGU's. The CGU includes both the E&E CGU and CGU's related to oil and natural gas interests for that area, but not larger than a segment.

5. Bank debt

As at December 31, 2011, the $26,245,533 (2010 – $5,559,208) reported amount of bank debt was comprised of $24,450,000 (2010 – $4,600,000) drawn on the revolving operating demand loan and $1,795,533 (2010 – $959,208) of bank overdraft. The Company is subject to a financial covenant with respect to working capital, which the Company was in compliance with at December 31, 2011.

The facility is secured by a fixed and floating charge on the assets of the Company and is secured by a general security agreement.

As at December 31, 2011, the maximum amount available under the revolving operating demand loan was $40,000,000 (December 31, 2010 – $12,000,000) at an interest rate of bank prime plus 1.0% per annum, payable monthly.

6. Decommissioning liability

The following table presents the reconciliation of the carrying amount of the obligation associated with the decommissioning of the Company's property and equipment:

	2011	*2010*
Balance, beginning of period	$ **3,501,805**	$ 2,936,792
Liabilities incurred	**652,382**	384,333
Liabilities settled	**(117,761)**	(13,091)
Effect of change in rates	**502,585**	67,143
Accretion	**107,281**	126,628
Change in assumptions	**251,929**	–
Balance, end of period	$ **4,898,222**	$ 3,501,805

The following significant assumptions were used to estimate the decommissioning liabilities:

	2011	*2010*
Undiscounted cash flows	$ **6,120,528**	$ 4,815,382
Discount rate	**1.51% - 3.35%**	2.7% - 3.61%
Inflation rate	**2%**	2%
Weighted average expected timing of cash flows	**8.7 years**	10.2 years

7. Share capital

a. Authorized

Unlimited number of common shares, without nominal or par value
Unlimited number of preferred shares, without nominal or par value

7. Share capital (continued)

b. Common shares issued

	Number of shares	*Amount*
Balance, January 1 2010	37,388,006	$ 47,066,815
Unit private placement *(i)*	16,000,000	4,009,700
Exercise of warrants *(ii)*	548,000	374,359
Flow-through share private placement (*iii)*	3,745,454	1,797,818
Private placement *(iv)*	3,300,000	1,617,000
Special warrant equity financing *(v)*	18,666,667	12,480,000
Exercise of stock options *(vi)*	70,000	83,944
Tax effect of flow-through shares	–	(125,000)
Share issue costs, net of $464,897 of future income tax	–	(1,394,688)
Balance December 31, 2010	79,718,127	$ 65,909,948
Transfer agent correction	(70)	–
Equity financing *(vii)*	23,632,500	17,251,725
Flow-through equity financing *(viii)*	12,500,000	8,500,000
Exercise of stock options *(ix)*	260,000	324,044
Exercise of warrants *(x)*	496,500	348,227
Share issue costs, net of $479,248 of deferred income tax	–	(1,438,625)
Balance, December 31, 2011	116,607,057	$ 90,895,319

i) On March 17, 2010, the Company completed a private placement of 16,000,000 units at $0.375 per Unit for gross proceeds of $6,000,000. Each unit was comprised of one common share of the Company and one half of one common share purchase warrant, with each full warrant exercisable anytime up to March 15, 2012, at a price of $0.50 per share, subject to certain earlier termination provisions. Management and directors subscribed for 2,671,334 units for gross proceeds of $1,001,750 or 16% of the financing. Finder's fees of $364,480 were paid in conjunction with the financing.

At the time of issuance, the fair value of the warrants was estimated to be $1,990,300 ($0.25 per warrant) based on the Black-Scholes fair value pricing model (note 8(e)) and $4,009,700 was ascribed to common shares.

ii) In March 2010, the Company issued 280,000 flow-through common shares on the exercise of 280,000 warrants at $0.50 per share for cash proceeds of $140,000 plus a pro-rata allocation of the warrants' fair value in the amount of $47,684. $14,000 is classified as a flow through premium liability until the tax effect is renounced.

From October 2010 to December 2010, the Company issued 268,000 common shares on the exercise of 268,000 warrants at $0.50 per share for cash proceeds of $134,000 plus a pro-rata allocation of the warrants' fair value in the amount of $66,675.

iii) On May 21, 2010, the Company completed a private placement of 3,745,454 flow-through common shares at $0.55 per share for gross proceeds of $2,060,000. An 8% cash commission was paid on the proceeds raised. $262,182 is classified as a flow through premium liability until the tax effect is renounced.

7. Share capital (continued)

b. Common shares issued (continued)

iv) On June 26, 2010, the Company completed a private placement of 1,650,000 common shares at $0.56 per share and 1,650,000 flow-through common shares at $0.60 per share for total gross proceeds of $1,914,000. A 6% cash commission was paid on the proceeds raised. $297,000 is classified as a flow through premium liability until the tax effect is renounced.

v) On October 25 and 28, 2010, the Company completed a special warrant financing for total gross proceeds of $13,000,000. The financing consisted of 8,666,667 flow-through special warrants priced at $0.75 each, issued on a flow-through basis and 10,000,000 common share special warrants priced at $0.65 each. Each special warrant was exercisable into common shares of the Company, and all unexercised warrants were deemed to be exercised the 5th day after receiving receipts from the various securities regulatory authorities for a final prospectus, which receipts were obtained on November 22, 2010. $520,000 is classified as a flow through premium liability until the tax effect is renounced.

vi) In November 2010, the Company issued 70,000 common shares on the exercise of 70,000 options at $0.50 per share for cash proceeds of $35,000 plus a pro-rata allocation of the options' fair value in the amount of $48,944.

vii) On March 8, 2011 the Company, closed a "bought deal" financing, completed by way of a short form prospectus, for the sale of 23,632,500 common shares of the Company at a price of $0.73 per share for gross proceeds of $17,251,725.

viii) On June 23, 2011 the Company, closed a "bought deal" financing, completed by way of private placement, for the sale of 12,500,000 flow through shares of the Company at a price of $0.80 per share for gross proceeds of $10,000,000. $1.5 million is classified as a flow through premium liability until the tax effect is renounced.

ix) The Company issued 260,000 common shares on the exercise of options at $0.50 per share for cash proceeds of $130,000 plus a pro-rata allocation of the options' fair value in the amount of $194,044.

x) The Company issued 496,500 common shares on the exercise of warrants at $0.50 per share for cash proceeds of $248,250 plus a pro-rata allocation of the warrants' fair value in the amount of $99,977.

c. Preferred shares

On March 8, 2011, the Company redeemed preferred shares for $1,000,000 cash plus outstanding dividends payable. As at December 31, 2010, the Company had 1,000,000 preferred shares issued and outstanding with an annual dividend rate of 5% payable semi-annually in cash or common shares of the Company. The preferred shares had an eighteen month term, at which time they were redeemable for $1,000,000 cash. Dividends of $8,960 were paid and expensed during first quarter of 2011. As the terms of the preferred shares provide for a mandatory redemption at a fixed amount, they were classified as a current financial liability in 2010.

8. Share based payments

The Company has an equity settled stock option plan under which the Board of Directors may grant options to directors, officers, other employees and key consultants. The purpose of the plan is to advance the interests of the Company by encouraging these individuals to acquire shares in the Company and thereby remain associated with, and seek to maximize the value of, the Company.

8. Share based payments (continued)

Under the plan, the number of shares reserved for issuance pursuant to the exercise of all options under the plan may not exceed 10% of the issued and outstanding common shares on a non-diluted basis at any time. The options expire not more than five years from the date of grant, or earlier if the individual ceases to be associated with the Company, and vest over terms determined at the time of grant.

During the year ended December 31, 2011, the Company granted options to purchase 4,175,000 common shares, the options vested immediately. The fair value of the options was estimated at $2,714,300 ($0.65 per option) using the Black-Scholes pricing model. $1,682,583 (2010 – 961,984) was recognized as stock-based compensation expense and $1,375,622 (2010 – 595,516) (including $343,905 for the tax effect) was capitalized to property and equipment.

The following tables summarize information about stock options outstanding as at:

	December 31, 2011		*December 31, 2010*	
	Options	***Weighted – average exercise price***	*Options*	*Weighted – average exercise price*
Opening	**7,808,800**	**$0.67**	3,542,255	$0.75
Granted	**4,175,000**	**0.69**	4,595,000	0.69
Exercised	**(260,000)**	**0.50**	(70,000)	0.50
Cancelled	**(255,000)**	**0.72**	(35,000)	(1.39)
Expired	**(115,000)**	**1.83**	(223,455)	(2.84)
Closing	**11,353,800**	**$0.65**	7,808,800	$0.67

The following provides a summary of the stock option plan as at December 31, 2011:

Range of exercise price	*Number outstanding*	*Weighted-average remaining contractual life (years)*	*Weighted-average exercise price*	*Number exercisable*
$ 0.25 – $ 0.50	2,640,000	2.92	$ 0.50	2,640,000
$ 0.51 – $ 0.75	6,440,000	4.07	0.66	6,440,000
$ 0.76 – $ 1.00	2,273,800	*3.30*	0.88	*2,273,800*
	11,353,800	3.65	$ 0.65	11,353,800

The Black-Scholes pricing model was used to estimate the fair value of options granted and warrants issued based on the following significant assumptions:

	2011	*2010*
Weighted average fair value per option	**$0.65**	$0.62
Risk-free interest rate	**1.51% to 2.81%**	1.59% to 3.09%
Expected volatility	**163% to 164%**	146% to 164%
Expected life	**5 years**	5 years
Forfeiture rate	**0%**	0%

9. Warrants

The following table summarizes information about warrants outstanding as at:

	December 31, 2011			*December 31, 2010*		
	Number of warrants	***Exercise price***	***Fair value ascribed***	*Number of warrants*	*Exercise price*	*Fair value ascribed*
Opening	**9,452,000**	**$0.50**	**$2,216,541**	2,000,000	$0.50	$340,600
Issued	**–**	**–**	**–**	8,000,000	0.50	1,990,300
Exercised	**(496,500)**	**(0.50)**	**(99,977)**	(548,000)	(0.50)	(114,359)
Closing	**8,955,500**	**$0.50**	**$2,116,564**	9,452,000	$0.50	$2,216,541

As at December 31, 2011, warrants had a weighted average remaining life of 9 months (2010 - 1.9 years). Subsequent to December 31, 2011 5,104,666 warrants were exercised and 2,430,834 warrants expired.

10. Net income (loss) per common share

Basic earnings per share was calculated as follows:

		2011		2010
Net income (loss) for the period	$	**1,385,698**	$	(1,745,150)
Weighted average number of shares (basic)				
Issued common shares at beginning of period		**79,718,127**		37,388,006
Stock options exercised		**215,836**		7,096
Transfer agent correction		**(70)**		–
Warrants exercised		**190,856**		246,871
Effect of shares issued		**25,835,575**		19,939,859
Weighted average number of common shares - basic		**105,960,324**		57,581,832

Diluted earnings per share was calculated as follows:

Weighted average number of shares (diluted)				
Weighted average number of shares (basic)		**105,960,324**		57,581,832
Effect of outstanding options		**1,110,721**		–
Effect of outstanding warrants		**6,710,099**		–
Weighted average number of common shares - diluted		**113,781,122**		57,581,832

The average market value of the Company's shares for purposes of calculating the dilutive effect of share options was based on quoted market prices for the period that the options were outstanding. Excluded from diluted earnings per share is the effect of 4,778,800 options (2010 – 3,543,605 options) as they are out of the money.

11. Income taxes

The provision for income taxes differs from the amount computed by applying the combined federal and provincial tax rates to the income (loss) before income tax. The difference results from the following:

	2011	*2010*
Income (Loss) before income taxes	$ **4,872,697**	$ (1,745,150)
Combined federal and provincial statutory income tax rate	**26.5%**	28.0%
Expected income tax expense (reduction)	$ **1,291,265**	$ (488,642)
Stock-based compensation and other non-deductible charges	**445,884**	506,312
Rate adjustments	**(101,290)**	91,173
Flow through share obligation	**1,329,613**	–
Other	**521,527**	79,600
Change in deferred tax asset not recognized	–	(1,042,790)
	$ **3,486,999**	$ (854,347)

The components of the net deferred income tax asset (liability) are:

	December 31, 2011	*December 31, 2010*	*January 1, 2010*
Decommissioning liability	$ **1,224,556**	$ 875,451	$ 734,198
Non-capital and capital loss carry-forwards	**–**	242,761	308,750
Share issue costs	**671,516**	386,904	21,632
Commodity price risk contracts	**372,969**	–	31,741
Property and equipment	**(7,088,585)**	(1,449,428)	(1,362,650)
Flow through share obligation	**375,000**	–	–
Deferred tax asset not recognized	**–**	(55,688)	(571,028)
	$ **4,444,544**	$ –	$ (837,357)

As at December 31, 2011, the Company has approximately $97 million of tax pools available for deduction against future taxable income.

12. Change in non-cash working capital

	2011	2010
Accounts receivable	$ **(12,356,717)**	$ (3,094,397)
Prepaid expenses, assets held for sale and deposits	**(1,075,488)**	(553,461)
Accounts payable and accrued liabilities	**16,289,903**	8,918,168
	$ **2,857,698**	$ 5,270,310

The changes in non-cash working capital has been allocated to the following activities:

Operating	$ **(9,676,331)**	$ (2,863,908)
Financing	**–**	190,988
Investing	**12,534,029**	7,943,230
	$ **2,857,698**	$ 5,270,310

13. Related party disclosure

The consolidated financial statements include the financial statements of Yangarra Resources Ltd. and the subsidiary listed below:

Name	Country of Incorporation	% equity interest 2011	% equity interest 2010
Yangarra Resources Corp.	Canada	100%	100%

Balances between Yangarra Resources Ltd. and its subsidiary, which is a related party, have been eliminated on consolidation and are not disclosed in this note. Details of transactions between the Company and other related parties are disclosed below.

During the year ended December 31, 2011 and 2010, the Company was charged or invoiced the following amounts by certain of its officers and directors and by companies controlled by certain of the Company's officers and directors:

		2011		2010
Administration and consulting fees	**$**	**237,694**	$	168,270
Production and capital expenditures		**339,896**		614,056
	$	**577,590**	$	782,326

Included in accounts payable and accrued liabilities at December 31, 2011 is $117,020 (December 31, 2010 – $29,668) relating to the above transactions. These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

During the year ended December 31, 2011 the Company entered into a trust agreement with an officer of the Company for an asset in Central Alberta used a field office. The Company holds the asset in trust while the officer retains legal title.

Compensation of key management personal:

		2011		2010
Compensation	$	**731,250**	$	508,241
Share-based payments		**1,385,279**		1,528,832
	$	**2,116,529**	$	2,037,073

14. Financial instruments and financial risk management

The Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, bank debt, commodity contracts and preferred shares. The carrying values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, bank debt and preferred shares approximate their fair values due to their relatively short periods to maturity.

14. Financial instruments and financial risk management (continued)

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is as follows:

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

The fair value of cash and bank debt is level 1 as it is determined by amounts held at/lent by financial institutions.

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements. The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with the risk management policies as set out herein:

b. Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with natural gas and liquids marketers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's natural gas and liquids are subject to credit review to minimize the risk of non-payment. As at December 31, 2011, the maximum credit exposure is the carrying amount of the accounts receivable and accruals of $16,109,194 (December 31, 2010 – $3,752,477). As at December 31, 2011, the Company's receivables consisted of $14,007,979 from joint venture partners and other trade receivables and $2,101,216 of revenue receivable from petroleum and natural gas marketers

Receivables from petroleum and natural gas marketers are typically collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any significant collection issues with its petroleum and natural gas marketers. All of the revenue accruals and receivables from petroleum and natural gas marketers were received in January and February 2012.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company mitigates the risk from joint venture receivables by obtaining partner approval of capital expenditures prior to starting a project. However, the receivables are from participants in the petroleum and natural gas sector, and collection is dependent on typical industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. Further risk exists with joint venture partners as disagreements occasionally arise which increases the potential for non-collection. For properties that are operated by the Company, production can be withheld from joint venture partners who are in default of amounts owing. In addition, the Company often has offsetting amounts payable to joint venture partners from which it can net receivable balances.

The Company did not provide for any doubtful accounts nor was it required to write-off any receivables during the year ended December 31, 2011. The Company would only choose to write-off a receivable balance (as opposed to providing an allowance) after all reasonable avenues of collection had been exhausted.

14. Financial instruments and financial risk management (continued)

As at December 31, 2011, the Company considers its receivables to be aged as follows:

Not past due	$	7,133,913
Past due by less than 90 days		5,398,582
Past due by more than 90 days		3,576,699
	$	16,109,194

d. Liquidity risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures.

To facilitate the capital expenditure program, the Company has a credit facility agreement, as disclosed in note 5, which is regularly reviewed by the lender. The Company monitors its total debt position monthly. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month. The Company anticipates it will have adequate liquidity to fund its financial liabilities through its future cash flows. The Company's financial liabilities are comprised of accounts payable and accrued liabilities, bank debt and the credit facility, which have expected maturities of less than one year resulting in their current classification on the balance sheet.

c. Market risk

Market risk consists of interest rate risk, currency risk and commodity price risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks. All such transactions are conducted in accordance with a risk management policy as set out herein:

iv. Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears interest at a floating rate. For the year ended December 31, 2011, if interest rates had been 1% lower with all other variables held constant, earnings for the period would have been $260,000 (2010 - $62,000) higher, due to lower interest expense. An equal and opposite impact would have occurred had interest rates been higher by the same amount. The Company had no interest rate swap or financial contracts in place at December 31, 2011.

14. Financial instruments and financial risk management (continued)

ii. Currency risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. All of the Company's petroleum and natural gas sales are denominated in Canadian dollars, however, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Company had no outstanding forward exchange rate contracts in place at December 31, 2011.

iii. Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand as well as the relationship between the Canadian and United States dollar, as outlined above.

As at December 31, 2011, the Company was committed to the following commodity price risk contracts for the sale of oil:

2012 Hedges:

- 100 barrels per day from January 1 to December 31, 2012 at a fixed price of $99.00 CAD per barrel;
- 200 barrels per day from January 1 to December 31, 2012 at a fixed price of $97.00 CAD per barrel;
- 200 barrels per day from January 1 to December 31, 2012 at a fixed price of $90.00 CAD per barrel;
- 100 barrels per day from January 1 to December 31, 2012 at a fixed price of $93.25 CAD per barrel; and
- 100 barrels per day from January 1 to December 31, 2012 at a fixed price of $100.00 CAD per barrel.

2013 Hedges:

- 200 barrels per day from January 1 to December 31, 2013 at a fixed price of $98.00 CAD per barrel; and
- 100 barrels per day from January 1 to December 31, 2013 at a fixed price of $97.50 CAD per barrel.

In addition, the Company entered into collars which provided a floor and a ceiling for the price it received for oil as follows:

- 100 barrels per day from January 1 to December 31, 2012 at a floor price of $95.00 CAD per barrel and a ceiling price of $110.00 CAD per barrel and
- 100 barrels per day from January 1 to December 31, 2012 at a floor price of $95.00 CAD per barrel and a ceiling price of $109.15 CAD per barrel.

14. Financial instruments and financial risk management (continued)

As at December 31, 2011, the Company was committed to the following commodity price risk contracts on the AECO basis:

- 2,000 mmbtu/day of AECO Basis for November 2011 to March 2012 at a price ranging from -$0.38 to -$0.42 USD/mmbtu.

The mark-to market on the hedges was in a loss position of $1,491,875 as at December 31, 2011 (2010 – $113,361). During the year ended December, 2011 $1,269,687 (2010 – $40,734) worth of contracts were settled.

15. Capital disclosures

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute its capital expenditure program, which includes expenditures in oil and gas activities which may or may not be successful. Therefore, the Company monitors the level of risk incurred in its capital expenditures to balance the proportion of debt and equity in its capital structure.

The Company considers its capital structure to include shareholders equity:

	December 31, 2011	*December 31, 2010*
Shareholders' equity	$ 76,627,244	$ 47,835,896

The Company monitors capital based on annual funds from operations and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the Board of Directors.

The Company manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations such as quality and basis differentials, royalties, operating costs and transportation costs.

In order to maintain or adjust the capital structure, the Company considers its forecasted funds from operations while attempting to finance an acceptable capital expenditure program including acquisition opportunities, the current level of bank credit available from the Company's lender, the level of bank credit that may be attainable from its lender as a result of petroleum and natural gas reserve growth, the availability of other sources of debt with different characteristics than existing debt, the sale of assets, limiting the size of the capital expenditure program and the issue of new equity if available on favorable terms. At December 31, 2011, the Company's capital structure was not subject to external restrictions.

16. Contingency

In December 2009, the Company terminated the Standstill Agreement that it had with an industry partner regarding a joint producing property and served that industry partner with a Statement of Claim issued from The Court of Queen's Bench of Alberta, by which the Company claims breach of the agreements between the parties, gross negligence and default of operator. The Company seeks judgment for specified and such further damages to be determined by the Court, as well as appointment as operator. The Company increased the statement of claim based on the information provided by the defendant and expects the matter to go to trial during 2012. The potential outcome of the lawsuit and claims are undetermined, however, they may be material. As the likely outcome of this litigation cannot be determined at this time, no provision has been made in these consolidated financial statements.

16. Contingency (continued)

In the normal conduct of operations, there are other pending claims by and against the Company. Litigation is subject to many uncertainties, and the outcome of individual matters is not predictable with assurance. In the opinion of management, based on the advice and information provided by its legal counsel, the final determination of these other litigations will not materially affect the Company's financial position or results of operations.

17. Commitments

The Company had until December 31, 2011 to incur $9,690,000 of qualifying flow-through expenditures related to flow-through shares issued in March, May, June and October 2010 of which all required expenditures have been incurred.

The Company has until December 31, 2012 to incur $10,000,000 of qualifying flow-through expenditures related to flow-through shares issued in June 2011. As at December 31, 2011 the Company has approximately $6 million remaining to spend on the 2012 flow thorough commitment.

The Company has entered into lease agreements for office premises, field equipment and Company vehicles with estimated minimum annual payments as follows

2012	$	185,571
2013	$	109,695

18. Transition to IFRS

The effect of the Company's transition to IFRS, described in note 1, is summarized in this note. In accordance with IFRS 1 "First-time adoption of IFRS", certain disclosures relating to the transition are also provided in this note.

IFRS 1 allows first time adopters of IFRS to elect a number of optional exemptions from the general principle of retrospective application of IFRS. The Company has taken the following optional exemptions:

Oil and Gas Exemption

In July 2009, the IASB published an amendment to IFRS 1 "Additional Exemptions for First-time Adopters", which introduces a first-time adoption exemption for first-time adopters that accounted under their previous GAAP for exploration and development costs for oil and gas properties in the development or production phases in cost centres that include all properties in a large geographical area (defined as full cost method under Canadian GAAP). Under the exemption, a first-time adopter may elect to measure oil and gas assets at the date of transition to IFRS on a deemed cost basis, but does not permit continued application of the previous GAAP accounting policy. The Company followed a full cost approach under Canadian GAAP and have elected to use this election to measure oil and gas exploration and production assets at the date of transition to IFRS on a deemed cost basis.

Share based payments

IFRS 2 "Share-based Payment" has not been applied to any equity instruments as all stock options were fully vested before January 1, 2010, the date of transition to IFRS.

18. Transition to IFRS (continued)

Decommissioning liabilities

An entity that uses the deemed cost oil and gas exemption under IFRS 1 may also use an additional exemption with respect to decommissioning liabilities on oil and gas properties encompassed by the full cost method under Canadian GAAP. As the Company has elected to apply the deemed cost oil and gas exemption, the Company has also elected to apply this exemption and as such, the Company has re-measured the decommissioning liability as at January 1, 2010 under IAS 37 provisions, and has recognized directly into deficit any differences between that amount and the carrying amount of the liabilities at January 1, 2010 as determined by Canadian GAAP.

Reconciliation of statement of financial position as previously reported under Canadian GAAP to IFRS

		December 31 2010			January 1 2010		
	Notes	CDN GAAP	ADJ	IFRS	CDN GAAP	ADJ	IFRS
Assets							
Current							
Cash and cash equivalents		11,678		11,678	-		-
Accounts receivable		3,752,477		3,752,477	658,080		658,080
Prepaid expenses and deposits		243,214		243,214	152,853		152,853
Assets held for sale		463,100		463,100	-		-
Commodity contract		-			-		
Total current assets		4,470,469		4,470,469	810,933		810,933
Property and equipment	a, b, c	61,475,178	1,788,274	63,263,452	38,830,516	(1,206,467)	37,624,049
Exploration and evaluation assets	a	-	639,892	639,892	-	1,206,467	1,206,467
Total assets		65,945,647	2,428,166	68,373,813	39,641,449	-	39,641,449
Liabilities							
Current liabilities							
Bank debt		5,559,208		5,559,208	8,195,069		8,195,069
Accounts payable and accrued liabilities		9,383,722		9,383,722	465,554		465,554
Preferred shares		1,000,000		1,000,000	-		-
Flow through Shares	d	-	1,093,182	1,093,182	-		-
Commodity contract		-		-	113,361		113,361
Total current liabilities		15,942,930	1,093,182	17,036,112	8,773,984		8,773,984
Preferred shares		-		-	1,000,000		1,000,000
Decommissioning liability	b	2,620,549	881,256	3,501,805	2,181,727	755,065	2,936,792
Deferred income tax liability		-		-	837,357		837,357
Total liabilities		18,563,479	1,974,438	20,537,917	12,793,068	755,065	13,548,133
Shareholders' Equity							
Share capital	d	62,955,605	2,954,343	65,909,948	43,019,290	4,047,525	47,066,815
Warrants		2,216,541		2,216,541	340,600		340,600
Contributed surplus		5,740,753		5,740,753	2,972,097		2,972,097
Deficit	b, d	(23,530,731)	(2,500,615)	(26,031,346)	(19,483,606)	(4,802,590)	(24,286,196)
Total shareholders' equity		47,382,168	453,728	47,835,896	26,848,381	(755,065)	26,093,316
Total liabilities and equity		65,945,647	2,428,166	68,373,813	39,641,449	-	39,641,449

18. Transition to IFRS (continued)

Reconciliation of net loss and comprehensive loss as previously reported under Canadian GAAP to IFRS

		Year Ended December 31, 2010		
	Notes	CDN GAAP	ADJ	IFRS
Revenue				
Petroleum and natural gas sales		6,534,377		6,534,377
Royalty Income		123,106		123,106
Royalties		(165,309)		(165,309)
		6,492,174		6,492,174
Commodity contract		154,095		154,095
		6,646,269		6,646,269
Expenses				
Production		1,820,683		1,820,683
Transportation costs		237,893		237,893
General and administrative		1,161,575		1,161,575
Interest and financing fees		265,251		265,251
Dividends		50,000		50,000
Stock-based compensation		1,746,939		1,746,939
Depletion and depreciation	c	6,066,568	(2,254,900)	3,811,668
Financing expense	b	173,703	(47,075)	126,628
Other expenses		25,129		25,129
		11,547,741	(2,301,975)	9,245,766
Loss before income taxes		(4,901,472)		(2,599,497)
Deferred income tax provision (recovery)		(854,347)		(854,347)
Net loss and comprehensive loss for the period		(4,047,125)	(2,301,975)	(1,745,150)

Explanation of the effect of the transition to IFRS

a) Exploration and evaluation assets

In accordance with IAS 16 "Property, Plant and Equipment", IFRS 6 "Exploration and Evaluation of Mineral Resources" and as a result of the Company using the oil and gas exemption, the Company reallocated costs relating to the exploration and evaluation phase from P&E to E&E assets. Under Canadian GAAP, capitalized E&E costs were included in P&E on the balance sheet. While the accounting treatment for E&E assets is unchanged under IFRS other than expensing of pre-acquisition costs, E&E and P&E are presented separately in the statement of financial position under IFRS. This has resulted in a reclassification from P&E to E&E assets at January 1, 2010 of $1,206,467 and at December 31, 2010 an adjustment of $639,892.

18. Transition to IFRS (continued)

b) Decommissioning liabilities

Under Canadian GAAP, decommissioning obligations are measured at fair value, incorporating market assumptions and discount rates based on the Company's credit adjusted risk-free rate at the time the obligation arose. Changes in the discount rate did not result in the re-measurement of the entire obligation. Changes in estimates that decreased the liability are discounted using the rate applied upon initial recognition while changes that increase the liability are discounted using the current discount rate. Accretion expense resulting from the increase in the liability due to the passage of time was recorded in depreciation, depletion and accretion expense.

IFRS requires adjustments to the liability to be made each period for changes in the timing or amount of cash-flow, changes in discount rates and the accretion of the liability. Estimated future cash flows have been discounted using the risk-free rate. Under IFRS, accretion expense is recorded as a borrowing cost. As described previously, the Company has elected to use the oil and gas exemption and the exemption from full retrospective application of decommissioning liabilities. The Company has re-measured the liabilities relating to resource assets as at January 1, 2010 using the risk-free rate, and this has resulted in an increase to the liability of $755,065 at January 1, 2010 with a corresponding increase in deficit.

The change to the decommissioning liability resulting from changes in the period end risk-free rate for the year ended December 31, 2010 was $132,293 with increases to the cost of the corresponding assets.

The reduction in accretion related to changes in the measurement basis of the liability $47,075 for the year ended December 31, 2010, recognized in finance expense.

c) Method of depletion

Canadian GAAP includes specific standards that prescribe the method for the calculation of depletion which does not exist under IFRS. Using full-cost accounting under Canadian GAAP, oil and gas assets are depleted using the unit-of-production method using remaining proved reserves. Under IFRS, the accounting policy for depletion includes proved and probable reserves, as this more accurately reflects the estimate for the usage of the resource assets. This has resulted in a decrease to depreciation and depletion expense of $2,254,900 for the year ended December 31, 2010.

d) Flow-through shares

Flow-through shares are a Canadian tax incentive which is the subject of specific guidance under Canadian GAAP, however there is no specific guidance under IFRS. Under Canadian GAAP, when flow-through shares are issued they are recorded at face value. The related deferred tax liability is established for the tax effect of the difference between the tax basis and the book basis of the assets when renounced and is recorded as a reduction of share capital. There is no income statement effect associated with the issuance of these shares.

18. Transition to IFRS (continued)

The Company has adopted a policy under IFRS where the proceeds from the offering are to be allocated between the sale of the shares and the sale of the tax benefit. The allocation is made based on the difference between the quoted market price of the existing shares and the amount an investor pays for the flow-through shares. A liability is established for this difference that is reversed upon renunciation of the tax benefit. The difference between this liability and the deferred tax liability is recorded as an income tax expense. This has resulted in a re-classification between deficit and share capital at January 1, 2010 of $4,047,525.

e) The following is a summary of the transition adjustments to Company's deficit from Canadian GAAP to IFRS

	Notes	December 31, 2010	January 1, 2010
Deficit as reported under Canadian GAAP		(23,530,731)	(19,483,606)
Decommishing liablities	b	(755,065)	(755,065)
Flow-through shares	d	(4,047,525)	(4,047,525)
Depletion and depeciation	c	2,254,900	-
Accretion	b	47,075	-
Deficit as reported under IFRS		(26,031,346)	(24,286,196)

f) Adjustments to the statement of cash flows

The transition from Canadian GAAP to IFRS had no significant impact on cash flows generated by the Company except that under IFRS, cash flows relating to interest are classified as operating, investing or financing in a consistent manner each period which has resulted in interest being classified as financing. Under Canadian GAAP, cash flows relating to interest were classified as operating.